TRANSCRIPT OF RECORD.

[illegible]PREME COURT OF THE UNITED STATES.

OCTOBER TERM, [illegible].

No. 66[illegible].

[illegible]DAVID H. GOODRICH, PLAINTIFF IN ERROR,

vs.

[illegible] H. EDWARDS, UNITED STATES COLLECTOR OF [illegible]ERNAL REVENUE FOR THE SECOND DISTRICT OF [illegible] STATE OF NEW YORK.

[illegible] TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

FILED [illegible].

([illegible])

(28,020)

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH, PLAINTIFF IN ERROR,

vs.

WILLIAM H. EDWARDS, UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF THE STATE OF NEW YORK.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

INDEX.

JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., DECEMBER 27, 1920.

1 L. 24—46.

Writ of Error.

UNITED STATES OF AMERICA, ss:

The President of the United States of America to the Judges of the District Court of the United States for the Southern District of New York, Greeting:

Because, in the record and proceedings, as also in the rendition of the judgment of a plea which is in the District Court, before you, or some of you, between David M. Goodrich, plaintiff-in-error, against William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York, defendant-in-error, a manifest error hath happened, to the great damage of the said David M. Goodrich, plaintiff-in-error, as is said and appears by his complaint, We, being willing that such error, if any hath been, should be duly corrected, and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the Supreme Court of the United States, at the City of Washington, together with this writ, so that you have the same at the said place, before the Supreme Court of the United States aforesaid, within thirty days from the date hereof, that the record and proceedings aforesaid being inspected, the said Supreme Court of the United States may cause further to be done therein, to correct that error, what of right and according to the law and custom of the United States ought to be done.

Witness, the Honorable Edward D. White, Chief Justice
2 of the United States, this 21st day of December, in the year of our Lord one thousand nine hundred and twenty, and of the Independence of the United States the one hundred and forty-fifth.

[Seal of District Court of the United States, Southern District of N. Y.]

[L. S.] ALEX. GILCHRIST, Jr.,
Clerk of the District Court of the United States of America for the Southern District of New York, in the Second Circuit.

The foregoing writ is hereby allowed.
LEARNED HAND,
U. S. District Judge.

3 [Endorsed:] L. 24—46. Supreme Court of the United States. David M. Goodrich, Plaintiff-in-Error, against William H. Edwards, United States Collector of Internal Revenue for

the Second District of the State of New York, Defendant-in-Error. (Original.) Writ of Error. Langdon P. Marvin, Attorneys for Plaintiff-in-error, 52 Wall Street, Borough of Manhattan, New York City. Due Service of a Copy of the within Writ of Error is hereby admitted this — day of —— 192–. U. S. District Court, S. D. of N. Y. Filed Dec. 21, 1920.

4 UNITED STATES OF AMERICA,
Southern District of New York, ss:

I, Alex. Gilchrist, Jr., Clerk of the District Court of the United States of America, for the Southern District of New York, in the Second Circuit, by virtue of the foregoing Writ of Error, and in obedience thereto, do hereby certify, that the following pages numbered from 5 to 31 inclusive, contain a true and complete transcript of the record and proceedings had in said Court in the cause of David M. Goodrich, Plaintiff-in-Error, against William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant-in-Error, as the same remain of record and on file in said office.

In testimony whereof, I have caused the seal of the said Court to be hereunto affixed, at the City of New York, in the Southern District of New York, in the Second Circuit, this 21st day of December, in the year of our Lord one thousand nine hundred and twenty and of the Independence of the United States the one hundred and forty-fifth.

[Seal of District Court of the United States, Southern District of N. Y.]

ALEX. GILCHRIST, JR.,
Clerk.

5 In the United States District Court for the Southern District of New York.

L. 24—46.

DAVID M. GOODRICH, Plaintiff,

against

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant.

Petition for Writ of Error.

To the Supreme Court of the United States of America:

The above named David M. Goodrich now appears before this Court and complains that in the records and proceedings had in this cause, and also in the rendition of the judgment in the above entitled cause, in the United States District Court for the Southern District of New York on the 17th day of December, 1920, manifest error hath

happened to the great damage of said plaintiff, all of which will more in detail appear from the assignment of errors which is filed with this petition.

Wherefore, the said plaintiff hereby prays that a writ of error may issue in his behalf from the Supreme Court of the United States, to the United States District Court for the Southern District of New York, for the correction of the errors and the reversal of the final order and judgment so complained of; that a transcript of the record, proceedings and papers in this cause, duly authenticated, may be sent to the said Supreme Court of the United States; that said writ of error operate as a supersedeas; that the amount of security which the petitioner shall give on said writ of error may be fixed,
6 and that upon the giving of said security all further proceedings in said Court be suspended and stayed until the determination of said writ of error by the Supreme Court of the United States; and that such other order and process issue as may cause the aforesaid errors and judgment to be corrected by the said Supreme Court of the United States.

Dated, New York City, New York, in said Southern District of New York, the 20th day of December, 1920.

LANGDON P. MARVIN,
Attorney for Plaintiff.

Office and Post Office Address, 52 Wall Street, Borough of Manhattan, New York City.

7 At a Stated Term of the District Court of the United States, Held in and for the Southern District of New York, at the Court House, in the United States Post Office and the Court House Building, in the Borough of Manhattan, City of New York, on the 21st Day of December, 1920.

Present: Hon. Learned Hand, U. S. District Judge.

L. 24—46.

David M. Goodrich, Plaintiff,

against

William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant.

Order Allowing Writ of Error.

The above named plaintiff, David M. Goodrich, having filed a petition for a writ of error and an assignment of errors in the above entitled action, and having also filed a bond in the sum of Two hundred and fifty Dollars ($250), and the said bond having been duly approved by the Court, it is now

Ordered that a writ of error be and the same hereby is allowed to have reviewed in the Supreme Court of the United States the record and proceedings and the judgment heretofore on the 17th day of

December, 1920, rendered in this Court in this cause; and it is further

Ordered that said bond shall operate as a supersedeas bond.

LEARNED HAND,
U. S. District Judge.

Endorsed: U. S. District Court, S. D. of N. Y. Filed Dec. 21, 1920.

8 *Summons—Law.*

United States District Court for the Southern District of New York.

L. 24—Page 46.

DAVID M. GOODRICH
against
WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of New York.

To the above-named Defendant:

You are hereby summoned to answer the complaint in this action, and to serve a copy of your answer on the plaintiff's attorney within twenty days after the service of this summons, exclusive of the day of service; and in case of your failure to appear, or answer, judgment will be taken against you by default for the relief demanded in the complaint.

Witness, the Hon. Learned Hand, Judge of the District Court of the United States for the Southern District of New York, at the City of New York, this 16 day of Decr. in the year one thousand nine hundred and twenty.

[SEAL.] ALEX. GILCHRIST, JR., *Clerk.*

EMMET, MARVIN & ROOSEVELT,
Plaintiff's Attorneys.

Office and Post Office Address, 52 Wall Street, Borough of Manhattan, New York City.

Endorsed: U. S. District Court, S. D. of N. Y. Filed Dec. 17, 1920.

9 U. S. District Court, Southern District of New York.

L. 24/46.

DAVID M. GOODRICH
versus
WM. H. EDWARDS, Coll'r of Int. Rev., 2nd Dist. of N. Y.

Notice of Appearance and Demand.

You will please take notice that I am retained by, and appear as attorney for, the Defendant in this action, and demand service of all

papers in this action upon me, at my office in the United States Court and Post Office Building, in the City of New York, Borough of Manhattan.

Yours,

EARL B. BARNES,
Asst. United States Attorney,
Attorney for Defendant.

New York, December 17, 1920.

To Emmet, Marvin & Roosevelt, 52 Wall St., Attorney- for Plaintiff.

10 [Endorsed:] U. S. District Court, Southern District of New York. David M. Goodrich versus Wm. H. Edwards, Coll'r of Int. Rev., &c. Notice of Appearance. Earl B. Barnes, Asst. United States Attorney, Attorney for Defendant. Due service of a copy of the within Notice is hereby admitted. Dated the 17th day of Dec. 1920. To Emmet, Marvin & Roosevelt, Plaintiff's Attorneys, 52 Wall St.

11 In the United States District Court for the Southern District of New York.

L. 24—46.

David M. Goodrich, Plaintiff,

against

William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant.

The plaintiff herein, by Emmet, Marvin & Roosevelt, his attorneys, for his complaint against the defendant alleges as follows:

I. The plaintiff at all the times hereinafter mentioned was and now is a citizen of the United Stated and a resident of the State of New York, and his place of business was and now is situated in the Borough of Manhattan, City, County and State of New York in the Second Internal Revenue District for the State of New York.

II. The defendant at all the times hereinafter mentioned was and now is a resident of the City, County and State of New York in said Second Internal Revenue District and was and now is the duly appointed and qualified United States Collector of Internal Revenue for said district.

III. The plaintiff was not at any of the times hereinafter mentioned and is not now in any sense engaged in the business of buying or selling stocks, bonds or other securities.

IV. Within the period required by law the plaintiff duly filed with the defendant the return required by law of his income for the year 1916, pursuant to the provisions of Title I of the
12 Revenue Act of Congress in effect September 9, 1916, entitled "An Act to Increase the Revenue and for other pur-

poses," and on the 10th day of May, 1917, the plaintiff pursuant to such return and to such act paid the amount of his income tax for the year 1916 as shown by said return, to the defendant, amounting to the sum of $2,148.26.

V. Thereafter the Commissioner of Internal Revenue, claiming to act pursuant to the provisions of said Revenue Act, re-examined the plaintiff's said return and assessed against the plaintiff an additional income tax for the year 1916; and thereafter by a notice and demand for tax dated May 6, 1920, the defendant demanded from the plaintiff the payment of said additional tax in accordance with said re-examination and assessment made by said Commissioner. In said notice and demand served by the defendant upon the plaintiff, demand was made for the payment of said additional tax on or before the 17th day of May, 1920, and it was stated that "failure to do so will cause a 5% penalty to accrue, with interest at 1% per month from due date until paid."

VI. Thereafter, the plaintiff, forced to act on or before said 17th day of May, 1920, and solely in order to avoid the payment of the penalty and interest specified in said notice and demand and the attachment of his property, on the 15th day of May, 1920, paid to the defendant under protest the sum of $3,490.87 on account of said additional income tax for the year 1916 so assessed and demanded as aforesaid.

VII. Thereafter, on or about the 6th day of August, 1920, the plaintiff filed with the defendant herein and with said Commissioner of Internal Revenue his appeal and application for a refund
13 of said sum of $3,490.87 so paid under protest, said appeal and application for refund being in the manner and form as provided in Sections 3220, 3226 and 3228 of the Revised Statutes of the United States, the provisions of law in that regard and the regulations of the Secretary of the Treasury pursuant to said law; and said appeal and application for refund was thereafter, on or about the 26th day of October, 1920, rejected and denied by said Commissioner of Internal Revenue and notice thereof given by him by letter to the plaintiff, excepting that said Commissioner in correction of an error reduced the total tax assessed against the plaintiff as aforesaid by the sum of $167.70, but said amount is not involved in this suit.

VIII. That portion of said additional income tax on account of which the sum of $3,145.91 (part of said sum of $3,490.87) was paid under protest by the plaintiff as aforesaid was based by said Commissioner of Internal Revenue solely on alleged income in the form of profits, amounting in all to $120,710.75, alleged by said Commissioner to have been derived by the plaintiff from the sale in 1916 of 3,600 shares of the common stock of the B. F. Goodrich Company, a New York corporation. That portion of said additional income tax on account of which the sum of $344.96 (the remainder of said sum of $3,490.87) was paid under protest by plaintiff as aforesaid was based by said Commissioner solely on

alleged income in the form of profits amounting in all to $13,236.22 alleged by said Commissioner to have been derived by the plaintiff from the sale in 1916 of 1,000 shares of stock of the United Verde Extension Mining Co.

IX. The facts with respect to said common stock of said B. F. Goodrich Company so sold as aforesaid are as follows:

1. On or about the 3rd day of August, 1888, the plaintiff's father, B. F. Goodrich, died, being then the owner of several thousand shares of the capital stock of the B. F. Goodrich Company, a corporation then organized under the laws of the State of Ohio.
14 By his will said decedent gave said stock of said company to his widow, the plaintiff's mother, who held the same for many years thereafter as a permanent investment. During her lifetime the plaintiff's said mother gave to the plaintiff certain shares of stock of said company, and on her death, on or about the 15th day of April, 1907, she bequeathed by her will other shares of stock of said company to the plaintiff. The plaintiff continued to own and to hold the said shares of stock of said company so acquired by him by gift from and under the will of his mother until on or about the 11th day of May, 1912, when a reorganization of said corporation occurred and the business and assets of said corporation organized under the laws of the State of Ohio were transferred to a new corporation by the same name, that is, the B. F. Goodrich Company, organized under the laws of the State of New York. Under the plan of reorganization the plaintiff exchanged his shares of stock so acquired by him, for cash and common stock of said new corporation, the B. F. Goodrich Company, organized under the laws of the State of New York, as of said 11th day of May, 1912, receiving certificates for the stock of said new New York corporation issued to him as of that date shortly thereafter. On said 11th day of May, 1912, the date when the plaintiff so acquired said common stock of said B. F. Goodrich Company, the New York corporation, shares of said stock were sold on the New York Curb Exchange, a public exchange in the City of New York, to be delivered as and when issued, at a price of about $81. a share, and plaintiff alleges that this was the fair market value of said stock on that date.

2. During the year 1916 the plaintiff sold 3,600 shares of said common stock of said B. F. Goodrich Company, the New York corporation, so acquired by him on said reorganization, as follows:

15

Date of sale.	Number of shares.	Cash received.
February 21..................	100	$7,283.50
" 23..................	100	7,283.50
" 23..................	150	10,756.50
" 23..................	200	14,267.00
" 23..................	50	3,560.50
" 23..................	100	7,108.50
March 17..................	1,000	74,835.00
April 13..................	450	39,925.75
May 29..................	50	3,791.75
May 29..................	250	18,958.75
" 29..................	50	3,798.00
" 29..................	250	18,958.75
" 29..................	400	30,334.00
July 8..................	450	32,484.75
Total	3,600	$269,346.25

3. On the 1st day of March, 1913, certain shares of the common stock of said B. F. Goodrich Company, the New York corporation, were sold on the New York Stock Exchange in the City of New York, a public exchange, at an average price of about $41.25 a share. Said Commissioner of Internal Revenue found this price of about $41.25 per share to be the fair market value of said common stock of said B. F. Goodrich Company, the New York corporation, on said 1st day of March, 1913, and, therefore, determined the total fair market value on said date of said 3,600 shares to be $148,635.50.

4. Said portion, amounting to $3,145.91, of the additional income tax, so assessed against the plaintiff and so paid by him under protest as aforesaid, was based by said Commissioner of Internal Revenue solely on the difference between the sum received by the plaintiff from the sale of said 3,600 shares of said common stock of said B. F. Goodrich Company, the New York corporation, amounting to $269,346.25, and the market value as found by the said Commissioner of Internal Revenue of said 3,600 shares of said stock on the 1st day of March, 1913, amounting to $148,635.50, the difference between said sums, amounting to $120,710.75, being found to be taxable income by said Commissioner.

16 5. The fair market value or price of said common stock of said B. F. Goodrich Company, the New York corporation, when it was acquired as aforesaid by the plaintiff on the 11th day of May, 1912, was the sum of $81. a share, and the total fair market value or price, on said date, therefore, of said 3,600 shares of said stock so sold by the plaintiff as aforesaid in the year 1916 was the sum of $291,600, whereas the total price received for said 3,600 shares when sold by the plaintiff in the year 1916, as aforesaid, was the sum of $269,346.25. In the year 1916, therefore, the plaintiff received for the shares of stock so sold the sum of $22,-

253.75 less than their aggregate fair market value at the date on which he acquired them.

X. The facts with respect to the sale of the shares of stock of the United Verde Extension Mining Company are as follows:

1. During the year 1912 the plaintiff subscribed for and bought for investment 1,000 shares of the capital stock of the United Verde Extension Mining Company and paid therefor the sum of 50¢ per share, or a total sum of $500 for said 1,000 shares.

2. On the 7th day of March, 1916, the plaintiff sold said 1,000 shares of stock of said United Verde Extension Mining Co. for the sum of $13,931.22.

3. On the 1st day of March, 1913, certain shares of the stock of said United Verde Extension Mining Company were sold on the New York Stock Exchange in the City of New York, a public exchange, at an average price of 69½¢ a share. Said Commissioner of Internal Revenue found this price of 69½¢ per share to be the fair market value of said stock of the United Verde Extension
17 Mining Company on said 1st day of March, 1913, and therefore, found the total fair market value on said date of said 1,000 shares to be $695.

4. Said portion, amounting to $344.96, of the additional income tax, so assessed against the plaintiff and so paid by him under protest as aforesaid, was based by said Commissioner of Internal Revenue solely on the difference between the sum received by the plaintiff from the sale of said 1,000 shares of stock of said United Verde Extension Mining Company, amounting to $13,931.22, and said market value as found by the said Commissioner of Internal Revenue of said 1,000 shares, on the 1st day of March, 1913, amounting to $695, the difference between said sums, amounting to $13,-236.22, being found to be taxable income by said Commissioner.

XI. As a conclusion of law, the plaintiff alleges with respect to the sales of securities hereinbefore set forth, that the alleged profits against which the Commissioner of Internal Revenue assessed and collected the additional income tax for said year 1916, the recovery of which is sought in this action, represent solely increase or increment of capital value of the aforesaid securities realized on the sale thereof over and above the fair market value thereof on the 1st day of March, 1913, and do not represent in any other respect income of the plaintiff for said year 1916; that said sums against which said additional income taxes have been assessed as aforesaid were in their inherent nature capital as distinguished from income, being the realization of the growth or increment in value of said securities while owned by the plaintiff and held by him as an investment; that no income tax is imposed by said Revenue Act of 1916 or by any other applicable act properly construed, upon any part of the amounts derived, as aforesaid, by the plaintiff from

any of the aforesaid sales of stock, and no income tax can
18 legally or constitutionally be assessed against such alleged profits or increase or increment of capital value, or any of them.

XII. As a conclusion of law, and for the purpose of preserving his claim that a constitutional question is involved in this suit, and of protecting his right to a direct appeal to or writ of error from the Supreme Court of the United States by reason thereof, in case said appeal or writ shall be necessary, the plaintiff further alleges that said Revenue Act of 1916 insofar as it has been or may be construed and enforced as authorizing the assessment and collection of any income or other tax upon the increase or increment in capital value realized upon the sale of the aforesaid securities, is invalid, unconstitutional and void, and in violation of the rights secured to the plaintiff by the Constitution of the United States, and more particularly by Article I, Section 2, Clause 3 thereof to the effect that "direct taxes shall be apportioned among the several States," and of Article I, Section 9, Clause 4 thereof, to the effect that "No capitation or other direct tax shall be laid unless in proportion to the census or enumeration hereinbefore directed to be taken;" that said alleged profits or increase or increment of capital value of said securities did not in whole or in any part or portion thereof constitute income and were not subject to tax as income within the meaning of the Sixteenth Amendment to the Constitution of the United States, which provides that "Congress shall have power to lay and collect taxes on incomes from whatever source derived without apportionment among the several States and without regard to any census or enumeration" and that said Revenue Act of 1916, insofar as it has been or may be construed and enforced, as aforesaid, is not authorized by said Sixteenth Amendment.

XIII. This is a suit of a civil nature at common law aris-
19 ing under the Constitution and Laws of the United States, and under such laws providing for internal revenue.

Wherefore, the plaintiff demands judgment against the defendant for the sum of Three thousand four hundred ninety and 87/100 Dollars ($3,490.87), together with interest thereon from the 15th day of May, 1920, and the costs and disbursements of this action, and such other relief as to the court may seem just.

EMMET, MARVIN & ROOSEVELT,
Attorneys for Plaintiff.

Office and Post Office Address, 52 Wall Street, Borough of Manhattan, City of New York.

20 UNITED STATES OF AMERICA,
State of New York, County of New York, ss:

David M. Goodrich, being duly sworn, deposes and says that he has read the foregoing complaint and knows the contents thereof, and that the same is true to his own knowledge except as to the matters therein stated to be alleged on information and belief, and that as to those matters he believes it to be true.

DAVID M. GOODRICH.

Sworn to before me this 15th day of December, 1920.
[SEAL.] H. N. JASPER,
Notary Public, Westchester County.

Certificate filed in New York County No. 70.

Commission expires March 30, 1921.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Dec. 16, 1920.

21 *Demurrer.*

United States District Court, Southern District of New York.

L. 24/46.

DAVID M. GOODRICH, Plaintiff,

against

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant.

The defendant, above-named, by Earl B. Barnes, Assistant United States Attorney for the Southern District of New York, his attorney, demurs to the complaint herein on the ground that the same does not state facts sufficient to constitute a cause of action.

Wherefore, defendant demands judgment, dismissing said complaint, together with the costs and disbursements of this action.

EARL B. BARNES,
Assistant United States Attorney,
Southern District of New York,
Attorney for Defendant.

Office & P. O. Address: U. S. Courts & P. O. Bldg., Borough of Manhattan, City of New York.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Dec. 17, 1920.

22 At a stated Term of the United States District Court for the Southern District of New York Held in the United States Court, in the Post Office Building, on the 17th Day of December, 1920.

Present: Hon. Learned Hand, United States District Judge.

L. 24/46.

DAVID M. GOODRICH, Plaintiff,

against

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant.

Order Sustaining Demurrer.

The issues of law raised by the demurrer of the defendant to the complaint of the plaintiff herein having duly come on to be heard by this Court at a Stated Term thereof, on the 17th day of December, 1920, after hearing Richard S. Holmes, Esq., Assistant United States Attorney, of counsel for the defendant in support of said demurrer, and Langdon P. Marvin, Esq., attorney and of counsel for the plaintiff, in opposition thereto, and due deliberation having been had thereon,

Now, upon motion of Earl B. Barnes, Esq., Assistant United States Attorney for the Southern District of New York and attorney for the defendant, it is

Ordered, that the said demurrer be and the same hereby is in all respects sustained; and it is further

Ordered, that the complaint herein be and the same hereby is dismissed; and it is further

23 Ordered, that the defendant have final judgment against the plaintiff and for his costs to be taxed.

LEARNED HAND,
United States District Judge.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Dec. 17, 1920.

24 United States District Court, Southern District of New York.

L. 24—46.

David M. Goodrich, Plaintiff,

against

William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant.

Final Judgment of Dismissal.

The issues of law raised by the demurrer of the defendant to the complaint of the plaintiff herein having duly come on to be heard before the Honorable Learned Hand, United States District Judge, at a Stated Term of this Court, and after hearing Richard S. Holmes, Esq., Assistant United States Attorney, of counsel for the defendant, in support of said demurrer, and Langdon P. Marvin, Esq., attorney and of counsel for the plaintiff, in opposition thereto, and due deliberation having been had thereon and an order having been duly entered on the 17th day of December, 1920, sustaining the said demurrer to the said complaint of the plaintiff herein and ordering that the said complaint herein be dismissed and further ordering that the defendant have final judgment against the plaintiff, and the defendant's costs having been taxed at the sum of $19.40.

Now, on motion of Earl B. Barnes, Esq., Assistant United States Attorney for the Southern District of New York, attorney for the defendant, it is hereby

25 Adjudged and decreed that the defendant, William H. Edwards, United States Collector of Internal Revenue for the Southern District of the State of New York, have final judgment against the plaintiff, David M. Goodrich, dismissing the complaint herein and that the said defendant recover of the said plaintiff the sum of nineteen & 40/100 Dollars ($19.40) costs as taxed, and that execution issue therefor.

Judgment signed this 17th day of December, 1920.

ALEX. GILCHRIST, Jr.,
Clerk.

U. S. District Court, S. D. of N. Y. Filed Dec. 17, 1920.

26 United States District Court, Southern District of New York.

L. 24—46.

DAVID M. GOODRICH, Plaintiff,

against

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant.

Assignment of Errors.

The plaintiff above named hereby assigns error to the record and proceedings and to the judgment entered in the above entitled cause, as follows:

I. The Court erred in sustaining the demurrer to the complaint herein.

II. The Court erred in holding that the differences realized on the sales of the securities in the year 1916 over their fair market value on the 1st day of March, 1913, as set forth in the complaint, being profits or increase or increment of capital value, were taxable as income within the intent and meaning of the Revenue Act of 1916 or of any other applicable act.

III. The Court erred in holding that the difference realized on sales of stock of the B. F. Goodrich Company in the year 1916 over their fair market value on the 1st day of March, 1913, as set forth in the complaint herein, were taxable within the intent and meaning of the Revenue Act of 1916, or of any other applicable act, for the reason that no profits or increase or increment of capital value, or income of any kind were received by the plaintiff, but on the contrary, actual losses suffered by him, on all of such sales with relation
27 to the fair market value of said stock when acquired by him.

IV. The Court erred in holding that the tax assessed as alleged in the complaint, and the Revenue Act of 1916, and any other applicable act, in so far as the same have been or may be construed or enforced as imposing said tax, were not unconstitutional and void and in violation of Article I, Section 2, Clause 3 of the Constitution of the United States as a direct tax not apportioned among the several states.

V. The Court erred in holding that the tax assessed as alleged in the complaint, and the Revenue Act of 1916 and any other applicable act, in so far as the same have been or may be construed or enforced as imposing said tax, were not unconstitutional and void and in violation of Article I, Section 9, Clause 4 of the Constitution of the United States as a direct tax not laid in proportion to the census or enumeration therein mentioned.

VI. The Court erred in holding that the tax alleged in the complaint was a tax on income within the meaning of the Revenue Act of 1916 or of any other applicable act.

VII. The Court erred in holding that the growth or increment of value in property held for investment, when realized by the sale of such property, is taxable as income under the Revenue Act of 1916 or under any other applicable act.

VIII. The Court erred in holding that the tax alleged in the complaint was a tax on incomes within the meaning of the Sixteenth Amendment to the Constitution of the United States.

IX. The Court erred in holding that the growth or increment of value in property held for investment, when realized by the sale of such property, is income within the meaning of the word "incomes" as set forth in the Sixteenth Amendment to the Constitution of the United States.

28 X. The Court erred in holding that the Revenue Act of 1916, or any other applicable act, in so far as the same has been or may be construed and enforced as imposing a tax as set forth in the complaint, is authorized by the Sixteenth Amendment to the Constitution of the United States.

Dated, New York City, the 20th day of December, 1920.

LANGDON P. MARVIN,
Attorney for Plaintiff.

Office and Post Office Address, 52 Wall Street, Borough of Manhattan, City of New York.

(Endorsed:) U. S. District Court, S. D. of N. Y. Filed Dec. 21, 1920.

29 Bond of United States Fidelity and Guaranty Co. for $250, approved Learned Hand, J., filed December 21, 1920.

30 L. 24—46.

Citation on Appeal.

By the Honorable Learned Hand, one of the Judges of the District Court of the United States for the Southern District of New York, in the Second Circuit, to William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York, Greeting:

You are hereby cited and admonished to be and appear before the United States Supreme Court, to be holden at the City of Washington, within thirty days from the date hereof, pursuant to a writ of error filed in the Clerk's Office of the District Court of the United States for the Southern District of New York, wherein David M. Goodrich is plaintiff-in-error and you are defendant-in-

error, to show cause, if any there be, why the proceedings and judgment in said writ of error mentioned should not be corrected and speedy justice should not be done in that behalf.

Given under my hand at the Borough of Manhattan, in the City of New York, in the District and Circuit above named, this 21st day of December, in the year of our Lord One Thousand Nine Hundred and Twenty, and of the Independence of the United States the One Hundred and Forty-fifth.

LEARNED HAND,
Judge of the District Court of the United States for the Southern District of New York, in the Second Circuit.

31 [Endorsed:] L. 24—46. Supreme Court of the United States. David M. Goodrich, Plaintiff-in-Error, against William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York, Defendant-in-Error. (Original.) Citation. Langdon P. Marvin, Attorney for Plaintiff-in-Error, 52 Wall Street, Borough of Manhattan, New York City. Due Service of a Copy of the within citation is hereby admitted this — day of ——, 192—. —— ——, Attorney for Appellee. U. S. District Court, S. D. of N. Y. Filed Dec. 21, 1920. A copy of the within paper has been this day received at this office, Dec. 21, 1920. Francis G. Caffey, U. S. Attorney.

32 [Endorsed:] District Court of the United States for the Southern District of New York. David M. Goodrich, Plaintiff-in-error, against William H. Edwards, United States Collector of Internal Revenue, etc., Defendant-in-error. Transcript of Record on Appeal.

Endorsed on cover: File No. 28,020. S. New York, D. C. U. S. Term No. 663. David M. Goodrich, plaintiff-in-error, vs. William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York. Filed December 23d, 1920. File No. 28,020.

Substitution

Supreme Court of the United States,

October Term, 1920.

No. 663.

David M. Goodrich,
Plaintiff in error,

vs.

William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF IN ERROR.

William D. Guthrie,
Langdon P. Marvin,
Henry M. Ward,
Herbert Pope,
Rush C. Butler,
Of counsel for plaintiff in error.

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TABLE OF CASES CITED

SUPREME COURT OF THE UNITED STATES,

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH,
Plaintiff in error,

vs.

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF IN ERROR.

This case comes before the court on writ of error to the District Court of the United States for the Southern District of New York to review a judgment entered on December 17, 1920, sustaining a demurrer to the complaint on the ground of insufficiency. The facts pleaded and all inferences of fact to be drawn from the facts pleaded are, therefore, admitted. The plaintiff in error was plaintiff below.

STATEMENT.

The complaint on its face presents the same question of constitutional law as is presented in *Merchants' Loan and Trust Company* v. *Smietanka*, No. 608, and *Eldorado Coal and Mining Company* v. *Mager*, No. 609, of the present term, now under advisement, and also involved in *Walsh* v. *Brewster*, No. 742 of the present term, namely, whether the growth or increment in value of property held for investment and constituting part of the taxpayer's capital, is, when realized by the sale

or conversion of such property, taxable as income under the Sixteenth Article of Amendment to the Constitution of the United States. The case also presents the question of construction of the Income Tax Law of 1916, as to whether or not a gain realized upon such sale by an individual investor is included within the terms of that act as an item of taxable income. The case further presents a question of construction, not involved in the other cases now under advisement, as to whether, when a loss has in fact been sustained by the taxpayer upon the sale of property acquired prior to March 1st, 1913, he is nevertheless taxable upon the difference between the price realized upon the sale and the value of the property upon March 1st, 1913, the selling price being lower than the price or value at the time of actual acquisition. In *Walsh* v. *Brewster* similar questions are involved with respect to investments acquired in 1899, and 1906, and sold in 1916, some at a profit and others at the same price at which they were purchased prior to March 1, 1913.

The plaintiff made his return and paid a tax on his concededly taxable income on May 10, 1917; but the Commissioner of Internal Revenue assessed an additional income tax, and the defendant made demand for payment of this additional tax on May 6, 1920. The plaintiff paid under duress and protest on May 15, 1920, the sum of $3,490.87 on account of the additional tax so assessed (record, p. 6). On August 6, 1920, the plaintiff filed his application for a refund of the additional tax so paid, which was denied by the Commissioner on October 26, 1920, and this action was thereupon duly brought against the Collector (pp. 6, 10).

The proceeds of the sale of two lots of securities are involved. Of the total of the tax of $3,490.87 so paid un-

der said reassessment, the sum of $2,145.91 was based upon alleged income in the form of alleged gain amounting to the sum of $120,710.75 claimed by the Commissioner to have been derived by the plaintiff from the sale in 1916 of 3,600 shares of the common stock of the B. F. Goodrich Company, a New York corporation (pp. 6, 7-8), and the remainder (viz. $344.96) was based by the Commissioner upon alleged income in the form of gain amounting to $13,236.22, derived by the plaintiff from the sale in 1916 of 1,000 shares of stock of the United Verde Extension Mining Company bought in 1912 as an investment (pp. 6, 9).

It was conceded below in and by the demurrer that the plaintiff was not at any of the times alleged in the complaint "in any sense engaged in the business of buying or selling stocks, bonds, or other securities" (p. 5); that the shares of capital stock of the Goodrich Company were received by him in May, 1912, upon a reorganization, in exchange for stock acquired by him in or prior to 1907 partly through gift and partly through inheritance from his mother, and that the shares of the Mining Company were acquired in 1912 through subscription and purchase for investment (pp. 7, 9). The questions presented, therefore, arise solely in connection with property held as investment and in no sense, as the demurrer admits (p. 5), in connection with the transaction of a trade or business.

The facts with respect to the stock of the Goodrich Company are as follows (pp. 7-9):

The plaintiff's father, B. F. Goodrich, died in August, 1888, owning several thousand shares of stock of the B. F. Goodrich Company, a corporation of the State of Ohio. By his will he bequeathed this stock to his

widow, the plaintiff's mother. During her lifetime she gave the plaintiff a part of the shares of said stock, and on her death in 1907 bequeathed to him by her will other shares of said stock. The plaintiff continued to hold the same until May, 1912, when the Ohio Company was reorganized, and the business and assets transferred to a new corporation organized under the laws of the State of New York with the same name. The plaintiff thereupon exchanged his shares of stock in the Ohio corporation for shares of stock in the New York corporation and cash. On the date of such exchange, shares of this stock in the New York corporation were of the fair market value of $81 per share. The plaintiff sold 3,600 shares of said stock of the New York Goodrich Company, so received by him in May, 1912, on various dates in 1916 between February and July, at a total price of $269,346.25, the average price received on said sales being $74.82 per share, and the prices being in each instance less than $81 per share. The total value of the said 3,600 shares in May, 1912, was $291,600, and the plaintiff upon the sale thereof received $22,253.75 less than such value. On March 1, 1913, certain shares of said stock were sold on the New York Stock Exchange at an average price of about $41.25 per share. The Commissioner of Internal Revenue on this basis computed and determined the total fair market value on March 1, 1913, of the 3,600 shares so sold to be $148,635.50, and held that, with respect to the sale of said 3,600 shares of stock, the plaintiff in the year 1916 received a taxable gain equal to the difference between the market value of said stock on March 1, 1913, viz., $148,635.50, and the total sale price in 1916, viz., $269,346.25, and was, therefore, taxable on the sum of $120,710.75 as "net income."

With respect, consequently, to the shares of stock of the Goodrich Company, there was no growth or increment or accretion or gain whatever in value from the time of acquisition by the plaintiff until the time of sale, but, on the contrary, a depreciation or shrinkage in value, liquidated upon the sale in the sum of $22,253.75, which in fact constituted a loss to the plaintiff.

The facts with respect to the sale of the shares of stock of the United Verde Extension Mining Company are as follows (p. 9):

During the year 1912 the plaintiff subscribed for and bought for investment 1,000 shares of the capital stock of said mining company at fifty cents per share, making a total purchase price of $500, and on March 7, 1916, sold them for the sum of $13,931.22. On March 1, 1913, the stock of said mining company was quoted on the New York Stock Exchange at an average price of 69½ cents per share, and the Commissioner found this price to be the fair market value of said stock as of March 1, 1913, and the total market value on said date of said 1,000 shares to be $695. The Commissioner thereupon assessed an income tax against the difference between said valuation on March 1, 1913, and the sale price realized, amounting to $13,236.22, such sum representing the growth or increment in value of said investment from March 1, 1913, to the date of sale, March 7, 1916, and with respect to the same the plaintiff paid a tax of $344.96 (p. 6).

The controlling and conceded facts in the case at bar are, therefore, (1) that the plaintiff acquired and at all times held the securities in question as investments, and not in connection with the transaction of any trade or business carried on for gain or profit, (2) that on the

Goodrich Company's stock there was no gain whatever but an actual loss or dimunition of capital growing out of the ownership or use of or interest in such property, and (3) that the gain or profit realized on the Mining Company's stock was the result of the growth, increment, or increase in value of a capital asset owned and held for investment since 1912.

In an appendix to this brief the relevant and pertinent provisions of the Income Tax Laws of 1913 (38 Stat. 166) and 1916 (39 Stat. 756), are printed in parallel columns with appropriate variations of type to denote the difference in phraseology.

Assignment of errors.

1. That the court below erred in sustaining the demurrer of the defendant.

2. That the court below erred in ruling that the said Act of Congress of September 8, 1916, as construed by it, was constitutional and within the taxing power delegated to Congress in and by the Sixteenth Article of Amendment to the Constitution of the United States.

3. That the court below erred in ruling that any part of the proceeds of the sale of the shares of the capital stock of the Goodrich Company constituted net income taxable under said Act of Congress.

4. That the court below erred in ruling that any part of the proceeds of the sale of the shares of the capital stock of the United Verde Mining Company constituted net income taxable under said Act of Congress.

I.

Review of prior statutes and decisions of the court.

Before discussing the question of the true meaning and scope of the term "incomes, from whatever source derived" contained in the Sixteenth Article of Amendment to the Constitution of the United States and its equivalent in the Act of 1916, it may be useful to review the prior statutes and decisions of this court in cases which involved questions of increase in value of capital investments. These cases arose respectively under three taxing laws of Congress, viz., (1) the Income Tax Act of 1867 (14 Stat. 471, 478, c. 169), (2) the Corporation Excise Tax Act of 1909 (36 Stat. 11, c. 6), and (3) the Income Tax Act of 1913 (38 Stat. 166, c. 16).

(1) The Income Tax Act of 1867 provided as follows (p. 478):

> "That there shall be levied, collected, and paid annually upon the gains, profits, and income of every person residing in the United States, or of any citizen of the United States residing abroad, whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, carried on in the United States, or elsewhere, or from any other source whatever, a tax of five per centum on the amount so derived over one thousand dollars, and a like tax shall be levied, collected, and paid annually upon the gains, profits, and income of every business, trade, or profession carried on in the United States by persons residing without the United States, and not citizens thereof. And the tax herein provided for shall be assessed, collected, and paid upon the gains, profits, and income for the year ending the thirty-first day of December next preceding the time for levying, collecting, and paying said tax. . . .

> "In estimating the gains, profits, and income of any person, there shall be included all income derived from interest upon notes, bonds, and other securities of the United States; profits realized within the year from sales of real estate purchased within the year, or within two years previous to the year for which income is estimated; . . . all other gains, profits, and income derived from any source whatever."

This court held in *Gray* v. *Darlington,* 15 Wall. 63, that the provisions above quoted did not include or tax an advance in the value of property during a series of years, although the entire amount of the advance had been realized in the taxable year by a sale of the property and conversion of the investment into money. Mr. Justice Field, delivering the opinion of the court, among other things, said (at p. 66):

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital."

In so deciding the court reached the same conclusion by substantially similar reasoning as was reached by the courts in England in construing the Income Tax Law of that country and it likewise recognized, as the English courts have done, the distinction between a trader and merchant on the one hand realizing a gain or profit in his business and an investor on the other hand realizing a gain or profit on an isolated transaction unconnected with his trade or business, which distinction is fully discussed in the cases cited below under point II.

In *Lynch* v. *Turrish,* 247 U. S. 221, the court followed *Gray* v. *Darlington,* and quoting from that case among other things said (at p. 230):

"This case has not been since questioned or modified.

"The Government feels the impediment of the case and attempts to confine its ruling to the exact letter of the Act of March 2, 1867, and thereby distinguish that act from the Act of 1913 and give to the latter something of retrospective effect. Opposed to this there is a presumption, resistless except against an intention imperatively clear. The Government, however, makes its view depend upon disputable differences between certain words of the two acts. It urges that the Act of 1913 makes the income taxed one 'arising or accruing' in the preceding calendar year, while the Act of 1867 makes the income one 'derived'. Granting that there is a shade of difference between the words, it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the disputes of purists. Besides, the contention of the Government does not reach the principle of *Gray* v. *Darlington,* which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore as 'arising or accruing', to meet the challenge of the words, in the last one of the years, as the Government contends, and taxable as income for that year or when turned into cash. Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

(2) It is not necessary to quote the language of the Corporation Excise Tax Law of 1909. As has been repeatedly pointed out by the court, that act "was not in any proper sense an income tax law, nor intended as such, but was an excise upon the conduct of business in a corporate capacity, the tax being measured by reference to the income in a manner prescribed by the act itself" (*Anderson* v. *Forty-Two Broadway Co.,* 239 U. S. 69, 72, citing previous cases.) Hence, it follows that the decisions under the Act of 1909 are not in point as to the

true meaning of the term "income" in an income tax statute or constitutional provision. The excise upon the conduct of business in a corporate capacity could properly be measured by either capital or income, gross or net, and include in such measure or standard, items not in their essence income at all. *Flint* v. *Stone Tracy Co.*, 220 U. S. 107. This fully distinguishes the cases arising under the Act of 1909, such *e.g.* as *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179; *Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189, and *United States* v. *Cleveland &c. Ry. Co.*, 247 U. S. 195. Moreover, the Act of 1909 was construed by this court in these cases as taxing corporations not upon all income received during the taxable year but "by a measure based upon the gainful returns from their business operations and property *from the time the act took effect*" and "conveying rather the idea of gain or increase *arising from corporate activities*" (*Doyle* v. *Mitchell Brothers Co.*, at pp. 183 and 185), and therefore as *excluding income that accrued before that date* (*Hays* v. *Gauley Mountain Coal Co.*, at p. 192). In thus construing the Act of 1909 as excluding gains or profits or income accruing prior to January 1, 1909, the court was not defining the term "income" in any sense beyond that applicable to the construction of the act then under consideration, nor was it intimating that increase in value of capital assets accruing prior to January 1, 1909, would not be income whilst a similar increase in value accruing after that date would be income. The Act of 1909 would have levied a constitutional excise tax if it had been measured by the entire receipts or the gross income of corporations without regard to when gains or profits had accrued, for what was taxed was not gains or profits or income as such but "the particular privilege of

doing business in a corporate capacity" (*Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 151). Therefore, the fact that Congress saw fit to adopt a measure for the excise tax it then levied, which included only gains accruing after a fixed date and excluded those accruing before that date, has little or no logical bearing or relevancy upon the question as to what does or does not constitute "income" within the meaning of the Sixteenth Amendment or within the intent of Congress in levying a direct tax without apportionment upon "incomes, from whatever source derived." The Corporation Tax of 1909 was expressly sustained only upon the ground that it was not in any respect a direct tax; or stated in other words, it was sustained only because it was an excise and not an income tax within the meaning of the latter term as commonly and currently understood and as passed upon in *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429; 158 U. S. 601. Of course, the selling of property by a corporation whether at a profit or a loss was the doing of business in a corporate capacity, and it was immaterial that the property sold was held by the corporation as a separate investment.

The point that the word "income" in the Act of 1909 meant gain or increase arising solely from corporate activities is further elucidated by the opinion of the court in *McCoach* v. *Minehill & Schuylkill Haven R. R. Co.*, 228 U. S. 295, 305-306, where it was held that the tax was not imposed upon a corporation not engaged in active business, though in the receipt of a large net income.

The recent Income Tax Laws have specifically dealt with *net* income, and in no case have they sought to tax the gross receipts or gross income of the taxpayer. Thus, in one clause of section 1 of the Act of 1916 the phrase

is "entire net income" (*a*), whilst in the following clause it reads "total net income" (*b*), but both refer to such part of the proceeds of sales, or dealings in real or personal property as does not represent capital but is independently "derived from capital, from labor, or from both combined." A tax on gross income from all sales would not be valid as an income tax,* although a tax would be valid if levied as an excise tax on the carrying on of a business or trade or profession, measured by gross income. *Spreckels Sugar Refining Co.* v. *McClain*, 192 U. S. 397, 413.

(3) The Income Tax Act of 1913, the first Income Tax Law under the Sixteenth Amendment, provided in par. A, subdiv. 1 (38 Stat. 166, c. 16) as follows (see appendix):

> "That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year." . . . etc.

It will be noted that in the Act of 1913 as well as in the Sixteenth Amendment, substantially the same formula was adopted as was contained in the Act of 1867. The phrase "all income derived from any source whatever" in the Act of 1867 became "incomes, from whatever source derived" in the Amendment, and the phrases levying the tax in the Acts of 1867 and 1913 are substantially and in effect the same, and especially so in the feature that the tax was to be levied "*annually* upon the entire net income arising or accruing from all sources in the preceding calendar year." The substitution of the words "arising or accruing" for the term "derived" involved but a negligible "shade of difference," as was pointed out in *Lynch* v. *Turrish*, *supra*.

As we have seen, the Act of 1913 came before the court

* In *Nicol* v. *Ames*, 173 U. S. 509, 521, the court recognized that a tax on all sales would be "really and practically upon property."

for construction in *Lynch* v. *Turrish*, 247 U. S. 221, in a case involving an advance in value of corporate assets and the distribution of the proceeds among the stockholders. It was then held that the rule in *Gray* v. *Darlington* applied and was controlling, clearly upon the ground that the provisions of the Act of 1913 were substantially the same as those of the Act of 1867, and that a mere advance in value realized on the conversion into money of an existing capital investment did not constitute income within the meaning of either act. It is true that the gain or profit in that case actually accrued before the Act of 1913 became effective, but that feature was emphasized only as bearing upon the intent of Congress and the construction of the statute. There is nothing in the reasoning of the opinion to indicate that, in the opinion of the court, if the advance had taken place or accrued after March 1st, 1913, the nature of the item would have been thereby changed from capital into net income and a different rule of law have been applicable. If in its nature essentially capital before the Act of Congress or the adoption of the Amendment, it certainly must continue to be capital thereafter. This should follow quite clearly and indisputably when it is recalled that in the cases of *Lynch* v. *Hornby* and *Peabody* v. *Eisner*, 247 U. S. 339 and 347, both argued at the same time as *Lynch* v. *Turrish*, and decided on the same day, it was held that it was immaterial and irrelevant that a surplus out of which corporate dividends were paid or payable had accumulated prior to the Act of 1913, because dividends from investments in stock "are commonly reckoned as dividends, and are expended as such by the stockholders without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation" (p. 344). The

basic and controlling difference between the two classes of cases was that in those like *Lynch* v. *Turrish* the transaction was not the declaration and payment of a dividend in the common understanding of that term or in the ordinary course of the business of a corporation, but was a conversion or transmutation of capital assets into money for final distribution among stockholders as capital, whilst in cases like *Lynch* v. *Hornby* and *Peabody* v. *Eisner*, the transactions constituted the declaration and payment of dividends in the ordinary, current and common acceptation of that term, and it was quite immaterial when the net earnings out of which the dividends were paid or payable had accrued to the corporation.

The case of *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, also arose under the Act of 1913. The facts were peculiar, but the fundamental inquiry was as to the nature of accumulations and increase in value of corporate assets prior to January 1st, 1913. The Government contended that as a dividend of the amount of these accumulations had actually been declared and practically paid in 1914, it constituted part of the corporation's gross "income" in the sense of something coming in, realized, received, arising, or accruing during the taxable term, and could not, therefore, be treated as capital assets instead of income. Answering this contention, the court said (at p. 335):

> "We must reject in this case, as we have rejected in cases arising under the Corporation Excise Tax Act of 1909 (*Doyle* v. *Mitchell Brothers Co., ante*, 179, and *Hays* v. *Gauley Mountain Coal Co., ante*, 189) the broad contention submitted in behalf of the Government that all receipts —everything that comes in—are income within the proper definition of the term 'gross income', and that the entire proceeds of a conversion of capital assets, in whatever form and under whatever cir-

cumstances accomplished, should be treated as gross income. Certainly the term 'income' has no broader meaning in the 1913 Act than in that of 1909 (see *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 416, 417), and for the present purpose we assume there is no difference in its meaning as used in the two acts. This being so, we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes of the act. And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer." (See also *Gulf Oil Co.* v. *Lewellyn*, 248 U. S. 71.)

There can be no doubt that if increase or increment in value of a capital investment became income whenever realized by conversion into money or other property, or in other words, if what was essentially a part of capital was changed in its nature and substance by the mere act of conversion or realization, the conclusions reached in the cases of *Gray* v. *Darlington*, *Lynch* v. *Turrish* and *Southern Pacific Co.* v. *Lowe*, were erroneous.

As discussed below, an examination of the Acts of 1913 and 1916 will show that Congress had clearly in mind that gains and profits or losses resulting or accruing from the trade or business of a taxpayer were to be regarded and treated as distinct and separate from gains and profits or losses resulting or accruing from isolated transactions* or capital investments not connected with the carrying on of any trade or business. The Act of

* The phrase "isolated transactions," to characterize transactions separate and apart from a taxpayer's regular trade or business, seems to have originated in a ruling of the Treasury Department under the Act of 1913 (Treasury Decision 2090, December 14, 1914). It may at times be difficult to determine what are or are not isolated transactions; but the question of fact is being constantly and necessarily passed upon by the Department, and similarly the question as to what are and are not "transactions entered into for profit," within the meaning of that phrase introduced in the Act of 1916. *Mente* v. *Eisner*, 266 Fed. 161; certiorari denied October 11th, 1920.

1916, moreover, for the first time introduced among the provisions as to allowable deductions, the following:

> "Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom."

Clearly, if Congress had not then had in mind the subject of gains and profits or losses resulting from transactions independent of business or trade, no such provision would have been inserted. It will further be noted that reference was made not to all transactions of the taxpayer not connected with his business or trade, but only to those "entered into for profit," language which plainly differentiated investments acquired for income from more or less speculative "transactions entered into for profit."

Under the Act of 1916, therefore, every taxpayer had to cover in his income tax return and the Government was called upon to investigate and differentiate the following among other items:

(1) The entire net income received or derived from any source whatever.

(2) Net income received from "the transaction of any business carried on for gain or profit."

(3) Losses actually sustained during the year, "incurred in his business or trade."

(4) Losses actually sustained during the year "in transactions entered into for profit but not connected with his business or trade. . . . to an amount not exceeding the profits arising" from similar transactions.

Capital losses, however, were not generally allowed to be deducted, because, it is proper and reasonable to infer, under neither the Act of 1916, nor the Act of 1913

upon which it was based, was it intended to tax the proceeds of capital assets sold at an increase over their cost any more than such proceeds were taxed under the Act of 1867.

The Government concedes that, of course, nothing is now income which was not income before the adoption of the Sixteenth Amendment and that mere increase in value, while it remains such, is not income but still capital. It urges, however, that an amount equal to any increase in value of property held for investment becomes income as soon as and whenever the investment is converted into cash or into other property. In other words, the contention is that although the entire investment is clearly capital while unconverted, a part becomes income upon conversion to the extent of any realized gain or profit.

The fundamental difference between the Government and the plaintiff is principally one of definition. If the term "incomes" in the Sixteenth Amendment and the statutes now in question means "all receipts—everything that comes in," then clearly even the proceeds of investments sold at a loss would be receipts and would be money coming in. This view having been rejected as unsound, a narrower sense or meaning of the term "income" must necessarily be accepted. The Government, therefore, suggests a meaning which it alleges obtains in current speech and common understanding, and contends that such meaning includes the realization by sale or conversion of increase in value of property held for investment.

There are three definitions by the court itself, as a result of the process of inclusion and exclusion, to which reference should be made, viz.:

> (1.) "Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated

merely as increase of capital" (*Gray* v. *Darlington*, 15 Wall. at p. 66).

(2.) "Advance in value is not income at all, but merely increase of capital and not subject to a tax as income" (*Lynch* v. *Turrish*, 247 U. S. at p. 231.)

(3.) "Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in,* being *'derived'*, that is, *received or drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; —*that* is income derived from properties. Nothing else answers the description. . . . Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term" (*Eisner* v. *Macomber*, 252 U. S. at pp. 207 and 214-5).

See also the cases cited below under point II as to the interpretation of the term "income," including *Smith* v. *Hooper*, 95 Md. 16, 26-31, where the Supreme Court of Maryland said:

"The word 'income' . . . is not synonymous with 'increase'. The value of stock may be increased by good management, prospects of business, and the like. But such increase is not income. The conversion of some of the shares into money resulted merely in substituting the cash received for the shares thus sold; and if the unsold shares represented nothing but capital, though capital of a largely increased value, the money obtained for the shares when sold can represent nothing but capital either. . . . That there has been a marvelous increase of the fund is manifest. Is that increase *income?* Increase and income are not synonymous terms. Until detached or separated from the shares whose value it enhances increase forms part of that value, and, therefore, part of

> the shares and if it be part of the shares themselves then, whilst it may be *profit*, it is in no sense income."

It is true that there are various other dictionary meanings of the term "income", some broad and some narrow and some usual and others rare or obsolete; but the current meaning in common speech is what the court has recognized and stated in the above quotations. A man not engaged in the business of buying and selling, say, real estate, who has held such property, it may be his home, for a series of many years, and who then sells it at an increase over what he paid, would not reasonably or sensibly regard or treat the gain thus made as income. He would not ordinarily include any part of the proceeds of such an isolated transaction, perhaps the only one of its kind in many years or a life time, as part of his annual income. On the contrary, if commonly prudent and conservative, he would regard and treat it as still an integral part of his permanent capital, to be used, if necessary, to offset or meet past or future capital losses, or to replace what he had sold with property equal in value or producing equal income.

Again: a man not engaged in the business of dealing in bonds and stocks, who had purchased securities for investment and not for speculation, who looked for safety of investment and certainty of return and not for profit on a sale or conversion thereof, would not reasonably or sensibly regard or treat an increase in value of a particular security when realized by sale or conversion, as part of his annual income. On the contrary, if ordinarily cautious and conservative, he would regard and treat it as still an integral part of his capital, to be used, if necessary, to offset and meet past or future depreciation and

capital losses in respect of other securities, or to replace what he had sold with other income producing securities.

Or, to take the case of an inheritance: a man inheriting a homestead or securities (as the plaintiff inherited the Goodrich stock in the case at bar) and years afterwards selling the same, could not reasonably regard or treat any part of the proceeds as income accruing during the year of the sale. It would all be still part of the capital he had inherited, and no part of it would be income within any reasonable meaning or acceptation of the term.

Stated in other words, the current meaning of the word "income" in common speech and according to common understanding is the return or gain which is periodically or annually derived from capital or from labor or from both combined, and not the extraordinary gain or profit which may be derived from an isolated sale of property held through a series of years for investment and in no sense connected with the taxpayer's business or bought by him for speculation or profit. Such an increase in value of an investment unrealized is always and properly regarded by private investors as essentially part of capital, and they do not regard or treat it as changed into income merely because it has been converted into money, it may be for the sole purpose of substituting another income-producing investment.

The authorities discussed below, it is submitted, establish the correctness of this conception of the current meaning and understanding of the term "income" as used in the Sixteenth Amendment and the Act of 1916.

II.

THE GROWTH OR INCREMENT IN VALUE OF REAL OR PERSONAL PROPERTY HELD FOR INVESTMENT, WHEN REALIZED BY SALE, IS NOT "INCOME" WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

The Sixteenth Article of Amendment to the Constitution of the United States, which was declared to be duly ratified on February 25, 1913 (37 Stat. 1785), provides as follows:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The Sixteenth Amendment added nothing to the subject matters theretofore taxable by the Congress, but merely dispensed with the requirement of apportionment as to one class of direct taxes, namely, taxes on incomes derived from the ownership of property. It clearly limits the taxing power of Congress thereunder to "incomes", and it does not authorize or permit an unapportioned tax levy upon capital in any form whatever or under any device. A tax levy that takes part of the principal or capital of a property asset of the taxpayer is necessarily a tax on property as distinguished from a tax on income derived from property, and is consequently a direct tax, which must constitutionally be apportioned. The reasoning which supports this conclusion is comprehensively and accurately stated by Mr. Justice Van Devanter in *Evans* v. *Gore,* 253 U. S. 245, 261-3, and by Mr. Justice Pitney in *Eisner* v. *Macomber,* 252 U. S. 189, 206. In the latter case, the learned Justice reviewed the effect and scope of the Sixteenth Amendment in the following language:

"As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the States of taxes laid on income. *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 17-19; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 112, *et seq.; Peck & Co.* v. *Lowe*, 247 U. S. 165, 172-173.

"A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overriden by Congress or disregarded by the courts.

"In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter may also have proper effect, it becomes essential to distinguish between what is and what is not 'income', as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

The requirement of apportionment imposed in and by sections 2 and 9 of Article I of the Constitution, therefore, remains in undiminished force and effect in respect of everything theretofore embraced within it, except only as to "taxes on incomes." Direct taxes on *capital* and the *proceeds* of capital still may not be constitutionally laid without apportionment. *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 637. The extent to which the Constitution remains operative in this relation, and the

extent to which the Amendment must be accorded supervening effect, are both to be determined only as it is made apparent what is "income" and what is not "income", within the meaning of that term as employed in the Sixteenth Amendment and in the light of the fact that other constitutional provisions equally obligatory (*Evans* v. *Gore, supra*) require that every tax on *property*, as distinguished from *income* derived from property, must be apportioned.

A.

As stated by this court in *Eisner* v. *Macomber*, it is, in construing the Sixteenth Amendment, "essential to distinguish between what is and what is not 'income', as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form". Constitutional provisions relating to the ordinary affairs of life necessarily must speak the current language as then commonly understood; otherwise they "would probably never be understood by the public" (*McCulloch* v. *Maryland*, 4 Wheat. 316, 407); and where, as in the Sixteenth Amendment, the provision plainly concerns the every day activities of men, it must be manifest that its purport and effect were intended to be readily solvable by the ordinary understanding of those to whom it was addressed. There is nothing to indicate that the members of the Congress that proposed the Amendment to the States or the state legislatures that ratified it understood the term "incomes" in any other than its commonly understood and judicially defined meaning. Indeed, while with respect to stock dividends, as is pointed out in the dissenting opinions of Mr. Justice Holmes and of Mr. Justice Brandeis in *Eisner* v.

Macomber (252 U. S. 220, 234, Mr. Justice Day concurring in the former and Mr. Justice Clarke in the latter), the law was by no means well settled in all the States that such dividends were capital and not income, with respect to increment of value realized upon the sale of property held for investment there was complete unanimity in holding that it was essentially capital and not income.

These considerations enable us immediately to lay to one side the suggestion, heretofore made by some judges and earnestly urged by the Government, that the term "income" embraces "everything that comes in" (see, *e. g., United States* v. *Oregon-Washington R. & Nav. Co.*, 251 Fed. 211, 212-3, 214; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 335), and the further suggestion that in the science of political economy or theoretical accounting the word has a peculiar, artificial, or technical meaning. *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414; *Lynch* v. *Turrish*, 247 U. S. 221, 227, 228. The former suggestion rests upon the bare etymological derivation of the word—an element which controls and influences common usage very slightly; and the latter yields to distinctions and doctrines of economists all but unknown to the ordinary individual, and which this court has declared are "such refinements [as] can hardly be deemed to have entered into the legislative purpose" (*Stratton's Independence* v. *Howbert*, *supra*). Manifestly, no substantial aid is to be derived from such lines of inquiry.

Prior to the adoption of the Amendment the meaning of the word income had been judicially defined by this court in *Gray* v. *Darlington*, by the highest courts of many of the States in the law of estates and trusts, and by the courts of Great Britain and of the British Dominions and Colonies in construing their Income Tax laws, as

excluding increment of value realized upon the sale of property held for investment. Probably no source is more enlightening than the decisions of the courts construing the term in question, for "it is a well-settled rule of construction that language used in a statute [or constitution] which has a settled and well-known meaning, sanctioned by judicial decision, is presumed to be used in that sense by the legislative body." *Kepner* v. *United States,* 195 U. S. 100, 124; *Norfolk Southern R.R. Co.* v. *Chapman,* 244 U. S. 276, 280-1.

B.

In *Gray* v. *Darlington,* 15 Wall. 63, decided in 1872, the question arose under the Income Tax Law of 1867, which levied a tax "upon the gains, profits, and income of every person . . . whether derived from any kind of property . . . or from any other source whatever." It appeared there that the plaintiff had in 1865 acquired some United States bonds in exchange for United States Treasury notes as an investment, and not in the course of any business, and that he had disposed of them in 1869 at an advance of $20,000 over the original cost of the notes. The Government attempted to tax this sum under the Income Tax Law of 1867 as "gains, profits and income"; but this court overruled its contention, and Mr. Justice Field speaking for the court used the following language (pp. 65, 66):

> "The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits, or income of the plaintiff for the year in which the bonds were sold. The answer which should be given to this question does not, in our judgment, admit of any doubt. The advance in the value of property during a series of years can, in no just sense, be con-

> sidered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. . . .
>
> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. *Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.*"

It will be noted that the court was then speaking of an advance in value which had been actually realized by sale within the taxable year. To the same effect as *Gray* v. *Darlington*, was the opinion of Mr. Justice Grier rendered in 1865, *Bennet* v. *Baker* (footnote to 15 Wall. 67), and the judgment of the Circuit Court in *Chicago, B. & Q. R. R. Co.* v. *Page*, 1 Biss. 461, 466, decided in 1864. And, as shown above at pp. 8-9, in *Lynch* v. *Turrish*, 247 U. S. 221, decided in June, 1918, this court followed and approved the ruling in *Gray* v. *Darlington*.

It must reasonably be presumed that Congress, when it proposed the Sixteenth Amendment, and the state legislatures, when they ratified it, intended to adopt this judicial interpretation and definition of the word income.

The conclusion is, therefore, fully warranted that both those who proposed the Sixteenth Amendment and those who ratified it understood and appreciated the force and effect of the decision of this court in *Gray* v. *Darlington*, and acted upon the belief that such a deliberate and authoritative definition of "income" and "capital" for purposes of taxation would constitute at once the measure and the limitation of the extension of the power of Congress "to lay and collect taxes on incomes . . . without apportionment," so as not to conflict with

the constitutional provisions requiring direct taxes on property to be apportioned.

C.

Particularly must it be apparent that this was the understanding of the state legislatures, since they knew that it was universally held to be the law in the United States that a gain realized by a trustee upon the sale of a part of the *corpus* or principal of a trust fund constituted capital or principal and not income, and belonged to the remainderman and not to the life-tenant, when the life-tenant was, by the express terms of the instrument creating the trust, entitled to all "income" arising from the trust estate. *Mercer* v. *Buchanan*, 132 Fed. 501, 508, 137 Fed. 1019; *Graham's Estate*, 198 Pa. St. 216; *Neel's Estate (No. 2)*, 207 Pa. St. 446; *Matter of Gerry*, 103 N. Y. 445, 450; *Thayer* v. *Burr*, 201 N. Y. 155, 157-8; *Boardman* v. *Mansfield*, 79 Conn. 634; *Carpenter* v. *Perkins*, 83 Conn. 11, 20; *Outcault* v. *Appleby*, 36 N. J. Eq. 73, 78; *Parker* v. *Johnson*, 37 N. J. Eq. 366, 368; *Guthrie's Trustee* v. *Akers*, 157 Ky. 649, 651; *Slocum* v. *Ames*, 19 R. I. 401; *Smith* v. *Hooper*, 95 Md. 16; *In re Armitage* (1893), 3 Ch. 337, 346; 28 Eng. & Am. Encyc. of L. & P. (2nd ed.) p. 917; 39 Cyc. 444; 40 *id.* 1788. The rule upon the subject is accurately stated by Prof. Irvine in his article on "Trusts" in the Cyclopedia of Law and Procedure, as follows (vol. 39, p. 444):

> "As instruments creating trusts frequently provide for the payment of income to one set of beneficiaries, and the *corpus* to another set, it often becomes necessary to decide what is included within the term 'capital,' and what within 'income.' In general, the capital or *corpus* of the trust estate includes not only the property which originally comes into the trustee's hands, but its

increase in value and whatever subsequently takes its place and represents it; hence it includes the money, including the profits, derived from a sale of stock, bonds, or other property of the trust estate, a common illustration of this being where the trustee, in order to protect the estate, buys in property at a foreclosure or other judicial sale and subsequently resells it at a profit."

Parker v. *Johnson*, 37 N. J. Eq. 366, 368, was a case precisely like the one which Prof. Irvine designated as "a common illustration" of the rule, and the Chancellor there said, referring to a profit realized upon the sale of a portion of the principal of a trust estate, that—

> "The profit [thus made] is not income. It was made by the trustee in the process of converting the investment, and, like a premium realized on the sale of government bonds in which the funds might be invested, it belongs to the fund."

The clear distinction between income and capital made and observed in cases affecting the rights of life-tenants and remaindermen was, it is proper to assume, familiar to most legislators. A large part of the invested capital of every community is held in trust subject to legal and equitable life estates with remainders over. Plainly, therefore, it is reasonable to assume that those who ratified the Amendment understood the word "incomes" in the light of its settled meaning in one of the commonest of legal relations.

That this common and familiar distinction did not directly appertain to taxation, is quite immaterial. Indeed, this court has so held. The learned district judge in *Towne* v. *Eisner*, 242 Fed. 702, 704 *et seq.*, attempted to distinguish the rule laid down in *Gibbons* v. *Mahon*, 136 U. S. 549, in respect of life-tenant and remainderman, by refusing to give it force and effect in cases involving income taxation. But this court reversed the

holding of the district judge upon this precise point, and treated as decisive the rule that the stock dividend there in question constituted capital and not income as between life-tenant and remainderman, saying in its opinion by Mr. Justice Holmes (245 U. S. at p. 426):

> "Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman."

No other result would be in accordance with logic. And this will at once be apparent if we assume, for the moment, that an increase realized by the sale of a part of the *corpus* of a trust estate, is taxable as income. Under the settled rule of law, that increase would become part of the capital of the trust and ultimately belong to the remainderman and not the life-tenant.

There is in this supposititious case no difficulty in understanding that such an increase is essentially capital and remains capital when transmuted by sale into money, and the case of the *Merchants Loan & Trust Company as Trustee of Ryerson*, No. 608, now under advisement presents that very question. When the trust relation disassociates income from capital and places the enjoyment of each in a separate individual, it is easy to perceive that growth of capital assets is not under such circumstances income, even when the process of investment and reinvestment at some period of time operates to convert the principal into cash for reinvestment. But, manifestly, what is capital and what is income, as between the life-tenant and remainderman in the case supposed, is not altered in its essential character and nature and turned from one class into another merely because both the remainder and the life estate

happen to be vested in the same individual at the same time, which is the case where property is owned outright by an individual as in the case at bar or by a corporation as in the *Eldorado* case, No. 609. Logically, there is in either of such cases no more justification for requiring income taxes to be paid out of capital, than there would be for depriving a life-tenant of a part of his income in order to pay for a benefit derived by the remainderman, or in depriving the latter of part of his capital to pay an alleged *income* tax, when he is the recipient of no income whatever.

D.

For many years prior to the adoption of the Sixteenth Amendment, the British courts had held and have since continued to hold that capital in any form, whether the realized increment of value upon the sale of property by an individual or of capital assets by a corporation, is not taxable as income under the British income tax laws which have been in force since 1842. This British authority is peculiarly important in view of the well-known fact that American income tax legislation came to us from England and has always been in large part patterned after the English enactments (Black on Income Taxes, 4th ed., sec. 30): and it should, therefore, reasonably be presumed that both the Sixteenth Amendment and the Income Tax Acts were framed in the light of the British precedents, and "that Congress, in adopting the language of the English act, had in mind the constructions given to these words by the English courts, and intended to incorporate them into the statute" (*Interstate Commerce Com.* v. *B. & O. R. R.*,

145 U. S. 263, 284). See also *Interstate Commerce Com. v. Del., L. & W. R. R.*, 220 U. S. 235, 253-4; *McDonald v. Hovey*, 110 U. S. 619, 628.

Both in 1909, when the Sixteenth Amendment was proposed by Congress to the several States, and in 1913, when it was finally ratified, it was the settled law in Great Britain that the growth or increment in value of investments, or of the capital assets of a corporation, when realized by sale or other disposition (as distinguished from profits so realized where such sale is the taxpayer's trade or business) was principal or capital and not income within the scope of the income taxing laws of Great Britain and the British Dominions. *Assets Co., Ltd. v. Forbes* (1897—Court of Exchequer, Scotland), 3 Tax Cases 542, 548; 24 Rettie 578, 586; *Scoble v. Secretary of State for India* (1903—House of Lords) [1903] A. C. 299, affirming [1903] 1 K. B. 494; *Californian Copper Syndicate, Ltd. v. Harris* (1904—Exchequer, Scotland), 5 Tax Cases 159, 165-6, 167; *Taxation Commissioners v. Mooney* (1907—Privy Council), [1907] A. C. 342, 350; *Hudson's Bay Co., Ltd. v. Stevens* (1909—Court of Appeal), 5 Tax Cases 424, 436, 437, 440; *Tebrau (Johore) Rubber Syndicate, Ltd. v. Farmer* (1910—Exchequer, Scotland), 5 Tax Cases 658, 664-5; *Commissioner of Taxes v. Melbourne Trust, Ltd.* (1914—Privy Council), [1914] A. C. 1001, 1010.

In *Assets Co., Ltd. v. Forbes, supra*, decided in 1897, Lord Young said:

> "I wish to give expression to the doubt which I entertain, and which I understand is shared by Lord Trayner very strongly, as to the cases in which we hold that a gain made by the sale of property at a price more than was paid for it may be regarded as income. . . . I should say that I have really no doubt that any person, or any com-

pany making a trade of purchasing and selling investments, will be liable in Income Tax upon any profit which is made by that trade. . . . But it is another proposition altogether that, where that is not a trade, a gain or loss upon the purchase and re-sale of property comes within the meaning of the Income Tax Acts. Take even proper traders; if proper traders sell their old premises and buy new ones, and sell the old premises at a higher price than they paid for them, investing in the purchase of the site and the erection of new premises the price which they got, I should say it was a totally untenable proposition that anything in excess of what they had paid for the old premises, perhaps 20 years before, and which they got at a better time, that any excess upon the price which they paid at the better time is income within the meaning of the Act. I do not think it is at all. It is no more so in the case of a trader's income than in the case of a private individual selling his house at more than he had paid for it, or selling his carriage or pictures at more than he had paid for them. That is not income in any sense; while a dealer in pictures, like a dealer in goods or a dealer in the buying and selling of houses, who made it a trade, would then come within the region of Income Tax."

In the case of *Californian Copper Syndicate, Ltd.* v. *Harris*, *supra*, decided in 1904, Lord Justice Clerk stated the rule as follows:

"It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business."

And Lord Trayner concurring declared that the case then before the court was not "the case of a company selling part of its property for a higher price than it had paid for it, and keeping that price as part of its capital, nor a case of a company merely changing the investment of its capital to pecuniary advantage" (5 Tax Cases at p. 167).

In *Taxation Commissioners v. Mooney, supra*, decided by the Privy Council in 1907, it appeared that the taxpayer had realized a profit on the sale of a mine in which he had invested, and it was held that this profit was not subject to taxation, Lord Macnaghten saying that the Privy Councillors agreed with the court below that—

> "A change in the form of property by a person who does not traffic in that kind of property cannot be regarded as producing income taxable under the Income Tax Acts."

The case of *Hudson's Bay Co., Ltd. v. Stevens, supra*, decided in the Court of Appeal in 1909, again presented the question in an important case involving a very large amount of tax; but the court adhered to the settled principle, Lord Justice Farwell saying:

> "It is well settled that income, not capital, is taxable under the Income Tax Acts. . . . It is clear, therefore, that a man who sells his land, or pictures, or jewels, is not chargeable with income tax on the purchase-money or on the difference between the amount that he gave and the amount that he received for them. But if instead of dealing with his property as owner he embarks on a trade, then he becomes liable to pay, not on the excess of sale prices over purchase prices, but on the annual profits or gains arising from such trade, in ascertaining which those prices will no doubt come into consideration."

And in *Tebrau (Johore) Rubber Syndicate, Ltd. v. Farmer, supra*, decided the following year (1910) in the Court of Exchequer of Scotland, where a rubber company

sold out all its property at a profit, Lord Salvesen spoke as follows:

> "I am unable to distinguish the position of the Appellants from that of a person who acquires a property by way of investment and who realises it afterwards at a profit. It is well settled that in such a case the profit is not part of the person's annual income liable to be assessed for income tax but results from an appreciation of his capital. No doubt if it is part of his business to deal in land or investments, any profits which in the course of that business he realises form part of his income; but the mere fact that a person or company has invested funds in the purchase of an estate which has subsequently appreciated and so has realised a profit on his purchase does not make that profit liable to assessment. Here the Appellant Company was formed primarily to acquire and develop a certain estate mentioned in the Memorandum and any other estates suitable for the cultivation of rubber; and to carry on the business of developing and cultivating the said estates.
>
> "No doubt power was also taken to sell any part of the undertaking and property of the Company; and I assume that the promoters of the Syndicate had in view from the first that it might become expedient to do so; but I am unable to infer from this fact, taken along with the ultimate sale of the entire assets to a new company, that it was part of the trade of the Syndicate to purchase and sell lands.
>
> "The fallacy of the view taken by the Commissioners is further apparent from the fact that the profit which ultimately results from an appreciation of value is not necessarily referable to the particular year in which it is realised.
>
> "In the case before us it is no doubt true that the Syndicate only existed a little more than a year; but that does not in the least affect the question whether the profits were made by way of annual income or resulted from appreciation of capital. Suppose the Company had been in existence for ten years before it sold its whole property at

a profit, how could it be said that the profit so made was income of the last year in which it existed?"

The striking resemblance between the reasoning of this opinion and that contained in the opinion of this court in *Gray* v. *Darlington*, 15 Wall. 63, will at once be perceived; and like *Gray* v. *Darlington*, the British authorities make it quite clear that the advance in the value of an investment realized otherwise than in the course of trade or business, "is not income at all, but merely increase of capital and not subject to a tax as income."

The rule to this effect, thus settled in England and Scotland, also prevails in the British Colonies and Dominions. As to Canada, see Pontifex's Canadian Income Tax, p. 23, and Breadner (Commissioner of Taxation) on The Business Profits War Tax Act and The Income War Tax Act, p. 18; as to Australia, see Bedwell's Australasian Judicial Dictionary (1920), p. 76; *Mooney* v. *Commissioners of Taxation* (1905), 3 Commonwealth Law Rep. 221, 228-9 (Griffith, C. J.), affirmed [1907] A. C. 342; *Webb* v. *Australian Deposit & Mortgage B'k, Ltd.* (1910), 11 *id.* 223, 227 (Griffith, C. J.); *Bohemians Club* v. *Acting Federal Commissioner of Taxation* (1918), 24 *id.* 334; *McLachlan* v. *Commissioner of Taxes*, [1912] South Australian Law Rep. 138 (Way, C.J.); *Shiels (Public Officer for the Bank of Adelaide)* v. *Commissioner of Taxes* [1912] *id.* 175; and as to South Africa, see Barnes' Income Tax Practice in South Africa (1919), pp. 137-40; *Commissioner of Taxes* v. *Booysen's Estate, Ltd.*, South African Law Rep. [1918] App. Div. 576.

The following extract from Bedwell's work, above referred to, accurately states the law upon the point as held, not only in Australia, to which this book particularly

refers, but in all the British Colonies and Dominions as well (p. 76):

> "The term 'income' as used in N. S. W. Land and Income Tax Assessment Act, 1898, includes 'profits, gains, rent, interests, salaries, wages, allowances, premiums, stipends, charges and annuities' (sect. 68). The proceeds of property sold are *primâ facie* capital and not income, and the term 'profits' does not include the difference between the cost price of property and the price at which it is afterwards sold, unless the buying and selling of such property is the ordinary business of the person alleged to be a taxpayer. Per Griffith, C. J.: *Mooney* v. *Commissioners of Taxation* (1905), 3 C. L. R. at pp. 228-229 . . . affirmed, [1907] A. C. 342 . . . followed, *Bohemians Club* v. *Acting Federal Commissioner of Taxation* (1918), 24 C. L. R. 334; *McLachlan* v. *Commissioner of Taxes, Rymill* (*Public Officer for Canowie Pastoral Co., Ltd.*) v. *Commissioner of Taxes* [1912] S. A. L. R. 138," [citing p. 77 also,] Griffith, C. J. in *Webb* v. *Australian Deposit & Mortgage Bank, Ltd.* (1910), 11 C. L. R. at p. 227, and *Shiels* (*Public Officer for the Bank of Adelaide*) v. *Commissioner of Taxes,* [1912] S. A. L. R. 175.

It is equally well settled by the decisions of the British courts that under their income tax laws capital losses are not deductible. *Smith* v. *Westinghouse Brake Co.,* 2 Tax Cas. 357 (1888); *Inland Revenue* v. *Western Steamship Co.,* 44 Sc. L. R. 715 (1907); *Royal Insurance Co.* v. *Watson,* 3 Tax Cas. 500; *Stott* v. *Hoddinott,* 7 Tax Cas. 85; *Watney* v. *Musgrave,* 1 Tax Cas. 272.

E.

Prior, therefore, to 1909 when the Sixteenth Amendment was proposed and 1913 when it was finally adopted, the word "income" was generally understood and had been quite generally defined as having a meaning distinct

from, and exclusive of, the increment of value realized upon the sale of property held for investment, by an individual, or the capital assets of a corporation. "In the construction of the language of the Constitution . . . we are to place ourselves as nearly as possible in the condition of the men who framed that instrument" (*Ex parte Bain*, 121 U. S. 1, 12) and "that which it meant when adopted it means now" (*South Carolina* v. *United States*, 199 U. S. 437, 448). So regarded, it is submitted that the terms of the Sixteenth Amendment could not in the period from 1909 to 1913 have been understood by Congress or the state legislatures as including within the power to tax "incomes" without apportionment, the power so to tax the growth or increment of value constituting capital accretions realized as a result of a change in investments made otherwise than in the course of the conduct of a trade or business. Certainly, it was not intended to authorize or permit the taxation of capital under the guise of taxing income.

If the views expressed by this court subsequent to 1913 be analyzed, this conclusion is strongly reinforced. The tax laid upon corporations by the Corporation Excise Tax Act of August 5, 1909, (36 Stat. 11, 112, c. 6, sec. 38) was, as shown above, an excise imposed upon the privilege of doing business in corporate form, and it was measured by income to the extent and in the special sense defined in the statute itself. The so-called "income" which measured this tax was not and was not intended to be the "income" signified and intended in and by the Sixteenth Amendment, and it has been repeatedly recognized by this court that the senses in which the terms were used are different in the two cases. The court declared in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414, 416, that—

> "As has been repeatedly remarked, the Corporation Tax Act of 1909 was not intended to be and is not in any proper sense an income tax law."

See also *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 150, 165; *United States* v. *Whitridge*, 231 U. S. 144, 147, 149; *Anderson* v. *Forty-Two Broadway Co.*, 239 U. S. 69, 72; *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 183; *Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189, 193, and *United States* v. *Cleveland C. C. & St. L. Ry. Co.*, 247 U. S. 195.

Where, on the other hand, a true income tax act was involved and capital profits were realized upon the change of an investment under circumstances in no wise related to the carrying on of business, as in *Gray* v. *Darlington*, 15 Wall. 63; or where under a true income tax law capital profits were realized, not in the course of the business, but upon the winding-up and termination thereof, which is after all but another mode or form of changing an investment, as was the case in *Lynch* v. *Turrish*, 247 U. S. 221, the court in each instance refused to consider such an increment of value when realized by sale or conversion as any part of taxable income, and declared that it remained capital, despite its conversion or transmutation into cash. And this court has recently stated that "enrichment through increase in value of capital investment is not income in any proper meaning of the term" (*Eisner* v. *Macomber*, 252 U. S. at pp. 214-5).

F.

An increase or increment in the value of an investment, not made or held as a part of any trade or business transaction, is plainly "a gain *accruing to* capital" and a "*growth or increment* of value *in* the investment,"

within the definition of the court in *Eisner* v. *Macomber, supra.* In no proper sense does it *proceed from* the property, as do rents, interest, dividends and other familiar forms of income; and such a gain, when realized, cannot properly be described as "*severed from* the capital" for it remains an integral part of the capital as much as if it had not been converted.

Before conversion into money, no one would question that the property, so held as an investment merely, was capital, although it then included the enhancement of value, and that it was not taxable except by the rule of apportionment. Bearing in mind that the Sixteenth Amendment is not to be "extended by loose construction" and that it is "essential to distinguish between what is and what is not 'income' . . . according to truth and substance, without regard to form" (*Eisner* v. *Macomber,* 252 U. S. at p. 206), we must find some distinct benefit to the taxpayer as *income* directly attributable to the conversion, before it can be declared that what the taxpayer now has is, not merely his capital, but income instead. Otherwise, the mere fact of conversion, that is, the form alone, would prevail over the substance and be made the decisive factor. Yet the court has declared, although in considering the Act of 1909, that "*subsequent change of form by conversion into money did not change the essence*" (*Doyle* v. *Mitchell Brothers Co.,* 247 U. S. at p. 187). Let us suppose the situation of an investor who desired to change his investments and to accomplish that result either by sale and new purchase or by exchange. In each instance, his efforts to change his capital from one form of investment and transfer it to another—not as a matter of business or trade, but solely as a change in the form of his investments—would

result in a loss of capital, exacted under the guise of an income tax, and would constitute a plain penalty upon capital imposed simply because of a change in the form of the taxpayer's capital investments.

Mere conversion of capital investments and change into money cannot, therefore, be determinative, even though more money is thus actually brought to hand than was originally put into the investment several years before. Otherwise, *Lynch* v. *Turrish,* 247 U. S. 221, was wrongly decided. There the taxpayer withdrew, upon the dissolution of his company, more money than he had put in, but only as much as his interest in the property in which he had his investment was then actually worth. All this was held to be capital and not income, despite the fact that it was received in money and was the outcome of a conversion.

It is true that it was stated in the opinion of the court in *Eisner* v. *Macomber,* 252 U. S. at p. 212, that—

> "It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment."

This was plainly an *obiter dictum,* and was probably the result of concessions made in the briefs of counsel upon the original hearing and the application for a rehearing as well as upon the rehearing. The proposition advanced in argument that realized capital profits were income was not involved in the case, was not disputed, and, being irrelevant, was not disputable. It was advanced by the taxpayer's counsel and, naturally, as it was for the advantage of the revenue was not disputed by the Government. Unless limited to sales of such stock in the course of

business transactions, this statement was inconsistent with *Gray* v. *Darlington*, 15 Wall. 63, *Gibbons* v. *Mahon*, 136 U. S. 549, and *Lynch* v. *Turrish*, 247 U. S. 221, and with the decisions of the state courts and of the courts of Great Britain and the British Dominions cited above, as well as with the reasoning in *Eisner* v. *Macomber* itself. The inconsistency will be immediately apparent if we assume that Mrs. Macomber had received the dividend stock in question as a trustee. Such stock would then, of course, have constituted a part of the principal of the trust fund and belonged as such to the remainderman and not to the life-tenant (*Gibbons* v. *Mahon, supra*); and it would still have constituted part of the *corpus* or capital if thereafter turned into cash, and the life-tenant would, in that event, still be entitled to no participation whatever in any of the proceeds of the sale. Nevertheless, according to the *dictum* quoted above, an income tax would have been payable in respect of this conversion of capital assets and change in the form of the investment of the trust estate. But, manifestly, the remainderman, who is not entitled to any income and only to capital, ought not to be required to pay a tax upon "income"; and, equally plainly, the life-tenant, who is entitled to the whole income but has not received any part of this converted stock dividend because, as to him, it constitutes capital, should not be called upon to pay a tax upon gains accruing to and received by another. This evident anomaly indicates the fallacy inherent in the passage quoted from the opinion in *Eisner* v. *Macomber*.

The foregoing views have recently found acceptance and approval in the case of *Brewster* v. *Walsh*, decided on December 16, 1920, by District Judge Thomas of Connecticut, 268 Fed. 207, now before this court for review *sub nom. Walsh* v. *Brewster*, No. 742.

It, therefore, follows that the word "income" had a well-established, clearly defined and unambiguous meaning at the time of the consideration and adoption of the Sixteenth Amendment, that this meaning excluded realized increase or increment of value on the sale of capital investments, that the Sixteenth Amendment does not authorize a tax upon capital growth, increment, or accretion realized on conversion of a permanent investment, and that if the Income Tax Law of 1916 can be construed as imposing such a tax, it is in that respect unconstitutional and void.

III.

THE INCOME TAX LAW OF 1916 DOES NOT LEVY A TAX UPON THE GROWTH OF INCREMENT IN VALUE OF CAPITAL ASSETS WHEN REALIZED BY SALE.

A.

The Act of 1913 did not tax increase in value of capital investments.

The framers of the original Income Tax Law of October 3, 1913 (c. 16, 38 Stat. 166) understood perfectly well the rule declared in the case of *Gray* v. *Darlington* by this court and the English cases cited and discussed above. Indeed, reference to the debates in Congress will show not only a clear understanding that increment in value of property held for investment was not in its nature income, but that it was not the intention of Congress in the Act of 1913 to tax realized increment of capital investments.

Thus, on April 26, 1913, the Income Tax Bill (H. R. 3321) was before the House of Representatives as Committee of the whole House on the state of the Union. (Congressional Record April 26, 1913.) Mr. Hull (the

draftsman of the income tax provisions) was explaining the bill in detail, and with reference to the Sixteenth Amendment, when the following occurred (Cong. Rec. vol. 50, part 1, at p. 513):

> "*Mr. Hull.* I will say to the gentleman frankly that it has been held in construing all these laws that I have observed, that unless the unearned increment is expressly made income it is not considered income in any sense of the word but simply increase of value or capital . . .
>
> *Mr. Mann.* What I really wanted to get at was not that, but whether it would relate back so as to cover all profit. Suppose a man bought property many years ago which probably last year was worth as much as it is this year. He sells it this year. What are his profits? How does he arrive at what his profits are?
>
> *Mr. Hull.* My judgment would be that as to an occasional purchase of real estate by one not a dealer or one making the buying and selling a business this bill would only apply to profits on sales where the land is purchased and sold during the same year.
>
> *Mr. Mann.* I hope that statement will remain in the *Record.*"

And at page 506 we find:

> "*Mr. Hull.* The rulings of the Treasury Department and the decisions of the courts of this country with respect to similar provisions of the old income tax laws and also the English rules of construction, all essential portions of which will be embraced in the Treasury regulations, will make clear the distinction between taxable profits or income on the one hand and capital or principal on the other."

So far as appears this view as to the Act of 1913 was not modified by Congress in connection with the Act of 1916. On the contrary, in the debate in the Senate on August 30, 1916 (53 Cong. Rec., part 13, p. 13407, *et seq.*) the question of taxing increase in value of capital investments was debated and the holding of this court in *Gray v. Darlington* read. Thereupon Senator Hitchcock said:

"I still am not able to understand it. I will put a case to the Senator. Suppose a man has purchased in a certain year stocks or bonds and two years thereafter there is an advance of $20,000. Is the man just taxed for one year only on the profit made?

"Mr. Clarke of Arkansas: He is not taxed at all on that because it ceases to be income and becomes capital."

The entire debate is quoted in the appendix, and whilst it is somewhat confusing, it is not improbable that the view of Senator Clarke, that an advance in value of stocks or bonds was capital, was acquiesced in by Senate and House.

At any rate, the ruling of this court in *Gray* v. *Darlington* was clearly brought to the attention of the Senate in August, 1916, and nevertheless the language adopted was substantially the same as that used in the Acts of 1867 and 1913. Surely, if it had been the intention then to tax increase in value of capital investments, clear and unambiguous language would have been used, in order to overcome "a presumption, resistless except against an intention imperatively clear" (Mr. Justice McKenna in *Lynch* v. *Turrish*, 247 U. S. at p. 230).

In neither the Act of 1913, nor the Act of 1916 was the growth or increment or increase of value of property held for investment expressly made income and taxed as such. As Mr. Hull stated in 1913, the rule of statutory construction, which he correctly gathered from the decisions discussed under point II, *supra*, was that "unless the unearned increment is expressly made income it is not considered income in any sense of the word but simply increase of value or capital." Hence, if we had no constitutional provision commanding that essentially direct taxes (such as a tax on the

proceeds of the sale of property or the substitute therefor) should be apportioned, the rule of construction would reasonably be that no part of the proceeds of the sale of property held for investment and not in connection with the carrying on of a business or trade would be taxable as income unless expressly made so. However, logically a statute could not make that income which was not so in its very nature except as fixing a standard by which to measure a tax. If the original asset as capital could not be taxed except by the rule of apportionment, then manifestly it should logically follow that the proceeds of or substitutes for such capital assets were not taxable except by apportionment.

But however this may be, there can be no doubt that according to many authorities the increment or accretion in value of capital assets when realized had generally not been treated as coming within the term "income" unless expressly made so by the taxing statute, assuming *arguendo* only that Congress could, as the British Parliament could, make that income for the purposes of an income tax law which was not in truth and substance income at all. The statute before the court does not purport to make such increment or accretion income; it is very doubtful whether Congress intended to treat it as such, and it should not now be made so by administrative or judicial interpretation. So far as appears, Congress had no such specific intent and may have contemplated and intended quite the contrary.

The principles which should govern this point are succinctly stated by Mr. Justice McReynolds in the case of *Gould* v. *Gould*, 245 U. S. 151, 153, speaking for the unanimous court, in the following language:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their pro-

visions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen. *United States* v. *Wigglesworth*, 2 Story 369; *American Net & Twine Co.* v. *Worthington*, 141 U. S. 468, 474; *Benziger* v. *United States*, 192 U. S. 38, 55.

". . . The use of the word itself in the definition of 'income' causes some obscurity, but we are unable to assert that alimony paid to a divorced wife under a decree of court falls fairly within any of the terms employed."

If the court was thus unable to assert that annual payments of alimony received by a divorced wife fell fairly within the terms of the Income Tax Law of 1913, it must *a fortiori* be unable to assert that the realized increment or accretion of value of property held for investment falls fairly within any of the terms employed in that act or in the act of 1916, which in this respect is substantially the same.

The grave doubts which reasonably exist both as to the intent of Congress, as well as to the constitutional power to tax such increment at all except by apportionment, should be resolved in favor of the taxpayer. The Congress well knew, for it had been repeatedly admonished by this court, that it was bound to express its intention to tax increment of value of property held for investment in clear and unambiguous language. Thus, in *Eidman* v. *Martinez*, 184 U. S. 578, 583, Mr. Justice Brown speaking for the court said:

"It is an old and familiar rule of the English courts, applicable to all forms of taxation, and particularly special taxes, that the sovereign is bound to express its intention to tax in clear and unambiguous language, and that a liberal construction be given to words of exception confining the

operation of duty. *Warrington* v. *Furbor*, 8 East, 242, 247; *Williams* v. *Sangar*, 10 East, 66, 69; *Denn* v. *Diamond*, 4 B. & C. 243, 245; *Tomkins* v. *Ashby*, 6 B. & C. 541; *Doe* v. *Snaith*, 8 Bing. 146, 152; *Wroughton* v. *Turtle*, 11 M. & W. 561, 567; *Gurr* v. *Scudds*, 11 Exch. 190, though the rule regarding *exemptions* from general laws may be different. *Cooley on Taxation*, 146; *In Matter of Enston*, 113 N. Y. 174, 177."

B.

The changes in phraseology in the Act of 1916 do not indicate any intent so to broaden the scope of the income tax as to include realized increment as an item of taxable income.

In the appendix the corresponding relevant portions of the Acts of 1913 and 1916 are printed in parallel columns, with appropriate variations in type to denote new matter added and old matter omitted or modified. From an inspection and comparison of the two acts, it will appear that the change which has a direct bearing upon the topic now under discussion was that in the Act of 1916 the phrase "entire net income received in the preceding calendar year from all sources" is used in place of the phrase in the Act of 1913, "entire net income arising or accruing from all sources in the preceding calendar year."

"Received," however, is a word of narrower, not broader, scope than "arising or accruing." Income which is earned or due may be said to "arise" or "accrue" and hence be within the Act of 1913, but the same income would not be within the Act of 1916 unless in fact received within the year by the taxpayer. Familiar instances are interest on real estate mortgages due late in

the calendar year but not actually paid until the following year, and interest on corporate bonds or other obligations not paid when accrued but subsequently collected. Instances could be multiplied, but those suggested are sufficiently typical, and in themselves afford an adequate explanation for the change in verbiage. Whilst there is, of course, a shade of difference, the substance is the same so far as the present question is concerned. *Lynch* v. *Turrish*, 247 U. S. at p. 230, and *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 345.

In the Act of 1916 a new subdivision (sec. 2 subd. (c), is added as follows:

> "For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

This subdivision, however, is limited by section 1 and the preceding subdivision (a) of section 2. By the former the tax is imposed on "net income," by the latter net income is specified and defined *in precisely the same words as in the Act of 1913*. Subdivision (c) must, therefore, be construed as applicable only to such gains derived from sales or dealings in property as are taxed. Subdivision (c) does not impose any tax, but merely states the basis of determining or computing the tax already imposed.

A new subdivision (Fifth) of section 5 is added allowing as an additional deduction—

> "In transactions entered into for profit but not connected with his (the taxpayer's) business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom."

Under the Act of 1913 there is no similar provision. *Mente* v. *Eisner*, 266 Fed. 161 (C. C. A. 2nd Cir; certiorari denied by this court October 11th, 1920, No. 447).

Far from this provision indicating any intent to tax realized increment, the only reasonable inference is directly to the contrary. The two acts plainly taxed as income gains derived from transactions entered into for profit, in the purchase and sale of real or personal property outside of the taxpayer's regular business, or otherwise entered into for profit, such as the usual speculations in securities on a stock exchange, produce exchange, board of trade, etc., or speculative purchases and sales of real estate as distinguished from investments. It is a matter of common knowledge that the great bulk of transactions on the exchanges are of this speculative nature, and they are entirely distinct from the purchase or acquisition of securities for permanent investment. Under the Act of 1913 losses were not deductible unless the taxpayer could establish that the nature of his transactions was such as to constitute "trade" and come within the term

> "losses actually sustained during the year incurred in trade."

Subdivision Fifth of section 5 was enacted to enable the taxpayer to deduct losses resulting from other "transactions entered into for profit but not connected with his business or trade." This clearly excluded transactions entered into for investment and not solely for profit.

It was, therefore, evidently the intent in the Act of 1916 to make the deductions allowed *pari passu* with the constituents of taxable income. The fact that losses outside of business were allowed only to this limited extent

is strongly indicative that capital profits realized on the sale of investments were not being taxed.

C.

The well settled meaning of the word "income" in common speech, as exclusive of realized increment, should be deemed to be the meaning of that word in the Act of 1916.

The intent of the act is plainly to tax the *annually* recurrent income of a taxpayer. The great mass of the people who invest their savings in real estate and in the purchase of investment securities productive of income certainly do not regard realized increase of value in such investments as "income". The realization of profit through sale is rarely the controlling motive in making such investments. They are not strictly entered into for profit but for investment. Safety and interest or dividends are the impelling factors. Under the Act of 1916 a loss sustained by the taxpayer on the sale of his home is not deductible. Is it not almost inconceivable that Congress would have taxed as income the profit realized by a householder or investor upon the sale of his home or of the securities representing his savings, without using language imperatively clear, when not permitting the deduction of losses in similar transactions?

The rule to be applied to the construction of the Acts of 1913 and 1916 is stated in *Black on Income Taxes*, 4th Ed., Sec. 30, p. 36, as follows:

> "It is another and ancient rule in the construction of statutes that the meaning of a doubtful word or phrase may be ascertained by reference to the meaning of other words or phrases with which it is associated, and that, where several things are referred to they are presumed to be of the same class when connected by a copulative conjunction

unless a contrary intent clearly appears. For example all the acts of Congress on the subject of income taxation, from 1862 to the present time, have associated together the words 'gains', 'profits' and 'income' as descriptive of the subject taxed, and the same is true of the income tax laws of some of the States. These words may be traced far back in the history of English taxation. The original income tax law of that country, enacted in 1799 imposed a tax on 'income' by that name, but the acts of 1842 and 1853 introduced the associated terms 'profits and gains' whence they were apparently borrowed by Congress in framing the Act of 1862 and have since persisted in use. Applying the rule above stated we are justified in asserting the following principles as applicable to the interpretation of the phrase in question. If it is doubtful whether or not a particular fund or acquisition is taxable as 'income' under the statute, it is not taxable unless it is income in the nature of 'gain' or 'profit'. If any item is clearly included in the description of 'gains' yet it is not taxable unless it is a gain in the nature of incomes or profits. And although the disputed item may be certainly a profit in one sense of the word, yet it is not taxable unless it be a profit accruing by way of gain or income."

D.

The provisions of the Act of 1916 with regard to deductions are inconsistent with the inclusion of realized increment as an item of taxable income.

Broadly speaking the deductions allowed are all such as relate to true income and not such as relate to isolated transactions and instances of the realization of increment of value on investments.

Under section 5 of the Act of 1916, the "Deductions Allowed" include (see appendix for quotation in full) the following:

(1) Necessary expenses *of the business or trade;* (2) interest; (3) taxes; (4) "losses actually sustained during the year incurred in his business or trade" . . . (5) losses to an amount not exceeding the profit in "transactions entered into for profit"; (6) worthless debts; (7) "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade", and (8) a special provision for oil and gas wells.

Then follow a prohibition of allowance of deductions, namely,

> "No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments,"

and a further prohibition of the deduction of the expense of restoring property for which an allowance was or had been made.

It is further to be noted that in the usual case of the sale of a taxpayer's home, or other real property, freehold or leasehold, held for investment, which is not used in his business or trade, there is no deduction allowed for exhaustion, wear and tear, and that no loss on the sale of a home, or of property acquired by gift or inheritance is deductible in fixing net income.

If it was intended to tax realized increment of value in investment property, there was a remarkable oversight in failing to provide for its taxation in the many instances where after the increment of value has accrued title to the property passed by gift, devise, bequest, or inheritance, and the property was then sold, without realization of further advance in value, by the donee, devisee, legatee, or heir. Obviously, by a mere gift of property

which had greatly increased in value the collection of any tax on the amount of such increase could be prevented.

E.

Full meaning and effect can be given to all the terms and provisions of the Act of 1916 through the construction advocated, namely, that realized increment of value was not included as an item of taxable income.

It is submitted that it has been decided by this court that the general expression "gains, profits and income from any source whatever", or its equivalent, contained in the acts of 1867 and 1913, did not include realized increase or increment of value of property held for investment, and that these general words could have ample scope if held to embrace only gains and profits properly and accurately within the current meaning of the term "income." So likewise as to the term "sales or dealings in property," it is submitted that its true intent and meaning is "*income* derived from sales or dealings in property", and does not include the conversion or transmutation into money or other property of a capital investment because the proceeds do not represent income. In other words, the controlling factor is not the sale or the dealing in property, for we are not discussing an excise tax, but *income* realized from such a transaction, that is to say, what is properly to be denominated income as distinguished from capital.

The words of the statute have an apt and appropriate function with respect to trade or business transactions and speculations, which will give adequate force and effect to the provision without necessarily including a gain

realized upon the increase in value of a capital investment. The distinction between the former and the latter is quite clear. Annual net profits of a business or trade are ascertained after deducting all the expenses and losses of the business from the gross aggregate of profits and other income, and this surplus alone constitutes the annual net income of such business or trade, regardless of the value of particular assets or of the profit or loss on particular transactions. But a gain derived from an isolated sale of an investment is in a totally different class and to be treated according to different rules. It is not part of the annual or other net income of a taxpayer in any proper or reasonable sense, but a profit resulting from an isolated and unusual transaction.

All the other terms of section 2 (a) of the act clearly relate to true income, and do not cover realized increment.

F.

The construction adopted and enforced by the Commissioner of Internal Revenue results in hardship, injustice and unreasonable discrimination among classes of taxpayers.

As examples of hardship and inequality attention may be called to the following instances:

(a) While in the case of a going business, or in transactions entered into for profit, losses are deductible, they are not deductible in other transactions, however much capital may thereby have become impaired.

(b) In the case of property held for a long period by an investor, or as an investment of trust funds by a fiduciary, losses are not deductible under the Act of 1916 be-

cause such transactions are not "entered into for profit." Hence, in the usual instance of losses incurred in one year on the sale of investments and profits realized in other years, or *vice versa,* the losses could not be deducted but the profits would be taxed and not allowed to be offset as against losses theretofore sustained.

(c) Under the progressively graded rates of tax, a tax upon the realization of the increment of value may be levied at a rate out of all proportion to the increment if apportioned *pro rata* during the period of accrual. This point has become of the greatest practical importance under the act of 1918. That it results in great hardship and injustice under the Act of 1917 is shown by the enormous tax exacted from the Ryerson Trust (No. 608) where the $700,000 profit conceded to have accrued over a period of four years and to belong to an undetermined number of beneficiaries, was taxed as a single income for one year without any deductions.

The sole theory upon which income taxes on increment of value are being levied is that such increment is not taxable as income until realized, and that, although it accrues from year to year during a series of years, it is not unjust that it should be taxed when actually realized by sale. This theory might work fairly if the increment were then apportioned over the period of accrual, retroactively, with appropriate provision for deductions of decrease in value of similar investments. This would be both fair and feasible. The act before the court, however, has no such provisions. The graded rates of supertax make the tax, when the increment of value is realized, out of all proportion as compared with the rate during the period of accrual, so that, as in the *Ryerson* case, the tax was at least ten times higher than it would have been if apportioned to the years when it actually accrued

among the beneficiaries entitled to the capital profit realized.

The rule to be applied under such circumstances is stated by the court in *Knowlton* v. *Moore*, 178 U. S. 41, 77, as follows:

> "We are, therefore, bound to give heed to the rule, that where a particular construction of a statute will occasion great inconvenience or produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute. *Bate Refrigerating Co.* v. *Sulzeberger*, 157 U. S. 1, 37; *Wilson* v. *Rousseau*, 4 How. 646, 680; *Bloomer* v. *McQuewan*, 14 How. 539, 553; *Blake* v. *National Banks*, 23 Wall. 307, 320; *United States* v. *Kirby*, 7 Wall. 482, 486."

G.

The contention of the Government based on practical construction is not well founded.

A contention made by the Government in the *Ryerson Trustee* and *Eldorado* cases (Nos. 608 and 609) will doubtless be repeated in the case at bar, namely, that the Treasury Department in 1914-1915 ruled that realized increment was included under the Act of 1913 as an item of taxable income and assessed and collected income tax accordingly, and that this practical construction must be deemed to have been adopted by Congress by the enactment of the Act of 1916 in substantially the same language as the Act of 1913. This contention, however, is somewhat inconsistent with the Government's further position that by substituting the word "received" for the words "arising and accruing" the whole scope and meaning of the act were in this respect clearly changed.

In answer to the contention based on practical construction it is submitted that there is no authority in

support of this contention applicable to the present situation, namely, a ruling by a department of the Government in direct violation of a decision of this court upon the exact point of construction in question, rendered many years prior to the departmental ruling, and never questioned by the courts but followed by a decision of this court directly to the contrary of the departmental ruling. *Gray* v. *Darlington*, the authority of which has never been questioned, is directly the opposite of the departmental ruling on this point, and in 1918 this court in *Lynch* v. *Turrish*, construing the Act of 1913 with respect to which such ruling was made, held the ruling to be erroneous. Furthermore, the very point as to the adoption of a departmental construction by the subsequent reenactment of the law so construed was necessarily involved, though not passed upon by this court, in *Gray* v. *Darlington*. The first federal income tax law enacted by Congress was that of 1861 (12 Stat. 309). This law was re-enacted, with changes in rate, in 1862 (12 Stat. 473); a similar law with further changes in rate was enacted in 1864 (13 Stat. 223, 281) and amended in 1865 (13 Stat. 469-479), and in 1867 (14 Stat. 471, 477), sections 116 and 117 of the act of 1864 were amended in the form quoted above at page 7 of this brief. In the appendix, the relevant portions of each of these earlier acts are printed. On comparing their phraseology, it will be noted that the four acts in so far as relevant are substantially identical. The last one of the series, that of 1867, was construed in *Gray* v. *Darlington*, decided in 1872. At the time of its enactment the practical construction, of taxing realized increment as income, had been enforced for some five or six years. As early as May, 1863, the Commissioner of Internal Revenue had ruled as follows:

"No. 110. Gains or profits realized from the sale of property during the year 1862, which property was purchased before the excise law went into effect, shall be returned as income for the year 1862. . . .

"Losses incurred in the prosecution of the business are a fair offset to gains derived from business but not from those portions of income derived from fixed investments, such as bonds, mortgages, rents, and the like." (Rulings of Internal Revenue Department, 1871, Government Printing Office.)*

Yet this court in *Gray* v. *Darlington*, decided in 1872, ignored these definite and long established rulings of the Department.

That an erroneous construction by a department is in no way binding on the court was not only recognized in *Lynch* v. *Turrish* and *Southern Pacific Co.* v. *Lowe*, 247 U. S. 221 and 330, but directly ruled in *Merritt* v. *Cameron*, 137 U. S. 542, 552; *United States* v. *Tanner*, 147 U. S. 661, 663; *Houghton* v. *Payne*, 194 U. S. 88; *Savings Bank* v. *United States*, 19 Wall. 227, and *Studebaker* v. *Perry*, 184 U. S. 258, 269. In the case last cited the court said:

"The doctrine invoked is a useful one but its application should be restricted to cases in which the construction involved is really one of doubt and where those to be affected have relied on the practical construction, *and rights have accrued by reason of such reliance.*"

* The rulings of the Department were published by the Office of Internal Revenue in 1871, Government Printing Office.

IV.

As the sale or conversion of the stock of the Goodrich Company represented an actual loss, no part of the proceeds was taxable as income of the taxpayer.

Assuming, *arguendo*, that increase in value of capital when realized by sale is taxable as income under the Sixteenth Amendment and the Act of 1916, it is nevertheless submitted that no part of the proceeds of the sale of the stock of the Goodrich Company was taxable because such sale resulted not in any gain but in an actual loss to the taxpayer.

The record in the case at bar conclusively establishes that the plaintiff did not receive or realize any gain or profit whatever from the sale of the shares of the capital stock of the Goodrich Company, but as matter of fact sustained a loss or diminution of capital value of $22,253, instead of a gain or profit of $120,700 (pp. 8, 9).

Section 2 of the Income Tax Law of 1916 provides that "the net income of a taxable person shall include gains, profits, *and income* derived from sales or dealings in property," etc. The addition of the word "income" to the words "gains, profits," however, added nothing, and never should have been employed, for it served no useful purpose. It would, of course, be absurd to define income as being income. Mr. Justice McReynolds pointed out in the case of *Gould* v. *Gould*, 245 U. S. 151, 153, with respect to the word "income" in the Act of October 3, 1913, 38 Stat. 144, 166, that "the use of the word itself in the definition of 'income' causes some obscurity."

There should be no difficulty in concluding that within long recognized canons of statutory construction the general word "income" following the enumeration of the specific words "gains" and "profits" must be restricted to things of the same kind, *ejusdem generis*, as those specifically enumerated. As Mr. Justice Lurton said in *United States* v. *Stever*, 222 U. S. 167, 174:

> "In such circumstances, unless there is a clear manifestation to the contrary, general words, not specific or limited, should be construed as applicable to cases or matters of like kind with those described by the particular words."

This view is strongly reinforced by the fact that in the same section of the Act of Congress, the provision of section 2 in relation to March first, 1913, speaks only of *gain*, and that no reference is made to profits or income. The maxim *expressio unius est exclusio alterius* would seem to be clearly applicable. The language employed would then exclude "profits and income," if they mean something other or broader than "gains," and must be confined to the single subject of "gains." Such was undoubtedly the intention, for the provision actually reads as follows:

> "(c) For the purpose of ascertaining the *gain* derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

Obviously if the words "net income" in the preceding subdivision (a) of the same section had been intended to mean something different from "gains" and "profits",

the same terminology would have been used and repeated in subdivision (c).

It follows that, if we are to reject the rule of *ejusdem generis* and to hold that by the use of the word "income," as employed in subdivision (a) of section 2, it was intended to reach and cover something different from "gains" or "profits," then it must necessarily follow that *income* other than a *gain* does not come within the purview of subdivision (c) of the same section because the term "income" was not repeated there, and that there was, therefore, no authority to apply the standard of market price or value as of March first, 1913, as distinguished from the market price or value when the plaintiff acquired the stock of the New York Goodrich Company in May, 1912. It would then result that if there was no *gain* at all, but in fact and truth an actual loss or diminution of capital, as in the case at bar, the statutory provision enacted "for the purpose of ascertaining the *gain derived from the sale*," etc., and "determining the amount of such *gain* derived" would not apply.

To hold otherwise would be to re-write the statute in a way quite beyond the power of any court and to attribute to the law-making power an intent which would in many instances be unfair, unjust and oppressive to tax-payers who had received no gain or profit whatever and, indeed, nothing that would come reasonably within the "natural and obvious sense" of the word income authoritatively defined as "the gain derived from capital, from labor, or from both combined" (*Doyle* v. *Mitchell Brothers Co.*, 247 U. S. at p. 185; *Eisner* v. *Macomber*, 252 U. S. at p. 207). The closing clause of the amended

provision, namely, that it "shall be the *basis for determining the amount of such gain derived,*" plainly evidences the idea that the test or standard fixed in the subdivision should apply only where there was a "*gain derived,*" and not where there was actually a loss sustained.

Congress could not arbitrarily create a fictitious "gain," where none in fact existed, in order to levy an income tax on the transaction, when in final analysis such a tax would have to be paid clearly out of diminished capital and therefore be an unapportioned property tax as distinguished from an income tax. To constitute a gain there must, of course, be a realization of profit by sale over the cost of the property when acquired. The two dates—of acquisition and sale—and the value on each of them are essential elements. Congress could not fix an arbitrary date of acquisition so as to charge the taxpayer with a fictitious cost any more than it could fix an arbitrary date of sale or conversion. Plainly, the purpose of the provision in question was to segregate the amount of gain accruing after the adoption of the Sixteenth Amendment from any gain accruing before, only when a gain had actually accrued and been realized.

The fact that the date of March first, 1913, is adopted in the Act of 1916 likewise for the purpose of determining a loss, that is, "the basis for determining the amount of such loss sustained," is immaterial, because the allowance of the deduction of losses actually sustained is wholly a statutory concession, and Congress might, as it did in the Income Tax Act of 1913, c. 16, 38 Stat. 166, limit the losses allowable and exclude altogether as a deduction capital losses not sustained in carrying on a business or trade.

It is submitted that it is reasonably manifest that a construction of the Income Tax Law of 1916 which would practically result in levying a tax upon and measured by what is essentially diminished or reduced capital would be unconstitutional as being in substance and effect a direct tax payable solely in respect of capital or out of the proceeds of capital. At any rate, there are certainly "grave doubts upon that score." In such a case the rule in this court is to avoid a conclusion which might render a statute even of doubtful constitutionality (*United States v. Standard Brewery*, 251 U. S. 210, 220; *United States v. Jin Fuey Moy*, 241 U. S. 394, 401; *United States v. Delaware & Hudson Co.*, 213 U. S. 366), and to adopt a construction which will avoid such doubts, if reasonably permissible. Moreover, equally well-settled is the rule that any doubt as to the intent of a tax law will be resolved in favor of the taxpayer. *Gould v. Gould*, 245 U. S. 151; *Eidman v. Martinez*, 184 U. S. 578, 583-590.

Moreover, it has been the long established practice of this court to limit general terms, such as the word "income" in the case at bar, so as not to lead to injustice, oppression, or an absurd consequence, and to construe a statute according to its spirit and not according to its letter whenever the letter would render it so unjust or oppressive as to warrant the presumption that Congress could not reasonably have intended such a literal following of its language. It is certainly not reasonable to assume that Congress intended to tax as a "gain" what was in fact and truth an actual "loss".

Thus, in *United States v. Kirby*, 7 Wall. 482, 486, Mr. Justice Field defined the rule in the following language:

"All laws should receive a sensible construc-

> tion. General terms should be so limited in their application as not to lead to injustice, oppression, or an absurd consequence. It will always, therefore, be presumed that the legislature intended exceptions to its language, which would avoid results of this character. The reason of the law in such cases should prevail over its letter."

See also *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414; *Hawaii* v. *Mankichi*, 190 U. S. 197, 212; *Holy Trinity Church* v. *United States*, 143 U. S. 457, 459; *Pickett* v. *United States*, 216 U. S. 456, 461; *Knowlton* v. *Moore*, 178 U. S. 41, 77; *United States* v. *Palmer*, 3 Wheat. 610, 631.

It follows, therefore, that it is reasonably to be presumed that Congress did not intend to levy a tax on anything except "gains" actually received by the taxpayer. The standard of March first, 1913, was adopted and followed solely for the benefit of the taxpayer, so as to exclude "gains" which had accrued prior to that date. Assuming that increase in value of capital investments could be and was intended to be taxed as income, then the clause now in question was a concession to the taxpayer so as to exclude from taxation as income increases in value which had accrued prior to March first, 1913.

Conclusion.

For the reasons indicated above, it is submitted (1) that growth, increment, or accretion in value of property held for investment and then sold is essentially capital and not income, (2) that it was not the intention of Congress to tax such growth, increment, or accretion in value in and by the Act of 1916, and (3) that the test of market price or value on March first, 1913, is applicable only

where there has in fact been a gain, and not where there has been in fact a loss of capital.

The judgment of the court below should, therefore, be reversed.

Washington, February 28, 1921.

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APPENDIX.

Comparison of Income Tax Acts of 1913 and 1916.

The language of the Act of 1913 omitted in the Act of 1916 is placed in brackets and underscored; the new matter in the Act of 1916 is italicized. Matter common to both acts is in same type.

Act of 1913, (38 Stat. 166).	*Act of 1916, (39 Stat. 756).*
"A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon the entire net income [arising or accruing from all sources in the preceding calendar year to] every citizen of the United States . . . a tax of 1 per centum [per annum] upon such income . . .; and a like tax shall be assessed, levied, collected, and paid annually upon the entire net income [from all property owned and of every business, trade, or profession carried on in] the United States by [persons residing elsewhere].	"Sec. 1 (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income *received* in the preceding calendar year from all sources *by every individual, a* citizen *or resident of the* United States, a tax of *two* per centum upon such income; and a like tax shall be levied, assessed, collected, and paid annually upon the entire net income *received in the preceding calendar year from all sources within* the United States by *every individual, a nonresident alien* . . .
B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from	Sec. 2 (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from
salaries, wages, or compensation for personal service of whatever kind and in whatever form paid,	salaries, wages, or compensation for personal service of whatever kind and in whatever form paid,
or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or	or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or

personal, growing out of the ownership or use of or interest in real or personal property,	personal, growing out of the ownership or use of or interest in real or personal property,
also from interest, rent, dividends, securities, or the transaction of any [lawful] business carried on for gain or profit, or gains or profits and income derived from any source whatever, [including the income from but not the value of property acquired by gift, bequest, devise, or descent]." . . .	also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit,
	or gains or profits and income derived from any source whatever, . . .
	(b) Income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates, and also such income of estates or any kind of property held in trust, including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be . . .

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

Sec. 4. The following income shall be exempt from the provisions of this title:

The proceeds of life insurance policies . . . the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); interest upon the obligations of a State . . .; the compensation of the present President of the United States . . . and the Judges . . . and the compensation of all officers . . . of a State . . . .

"Deductions Allowed

"That in computing net income for the purpose of the [normal] tax there shall be allowed as deductions:

Sec. 5.. That in computing net income *in the case of a citizen or resident of the United States*

(a) For the purpose of the tax there shall be allowed as deductions

Appendix.

first, the necessary expenses actually paid in carrying on any business * * *

second, all interest paid within the year * * *

third, * * * taxes * * *

fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, [<u>or</u>] shipwreck, [<u>and</u>] not compensated for by insurance or otherwise;"

First. The necessary expenses actually paid in carrying on any business *or trade* * * *

Second. All interest paid within the year * * *

Third, Taxes * * *

Fourth, Losses actually sustained during the year, incurred *in his business or* trade, or arising from fires, storms, shipwreck, *or other casualty, and from theft, when such losses are* not compensated for by insurance or otherwise;"

Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom.

fifth, debts due to the taxpayer actually ascertained to be worthless and charged off [within] the year.

Sixth. Debts due to the taxpayer actually ascertained to be worthless and charged off *during* the year.

sixth, A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business.

Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business *or trade;*

[Provided, That] no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate,

[The net income from property owned and business carried on in the United States by persons residing elsewhere shall be computed upon the basis prescribed in this paragraph and that part of paragraph G of this section relating to the computation of the net income of corporations, joint stock and insurance companies, organized, created, or existing, under the laws of foreign countries, in so far as applicable.]

Non-Resident Aliens.

Sec. 6. That in computing net income in the case of a nonresident alien (a) For the purpose of the tax there shall be allowed as deductions—First, The necessary expenses actually paid in carrying on any business or trade within the United States.

Second. The proportion of all interest paid . . . on his indebtedness. . . .

Third. Taxes. . . .

Fourth. Losses actually sustained during the year, incurred in business or trade conducted by him within the United States . . . arising from fires, storms, shipwreck, or other casualty, and from theft . . . Provided,

That for the purpose of ascertaining the amount of such loss or losses sustained in trade, or speculative transactions not in trade, from the same or any kind of property acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss or losses sustained;

[D. The said tax shall be computed upon the remainder of said net income of each person subject thereto, accruing during each preceding calendar year ending December thirty-first: Provided, however, that for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive, after deducting five-sixths only of the specific exemptions and deductions herein provided for.]

Appendix.

No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate,

and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made.

E. . . .
The tax herein imposed upon [annual] gains, profits, and income not falling under the foregoing and not returned and paid by virtue of the foregoing shall be assessed by personal return.

The tax herein imposed upon gains, profits and income not falling under the foregoing, and not returned and paid by virtue of the foregoing, shall be assessed by personal return. . . .

Appendix.

TEXT OF THE INCOME TAX ACTS OF THE CIVIL WAR PERIOD, 1861-1867, SO FAR AS RELEVANT.

Act of August 5, 1861, 12 Stat. 292, 309:

> "SEC. 49. That, from and after the first day of January next, there shall be levied, collected, and paid, upon the annual income of every person residing in the United States, whether such income is derived from any kind of property, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any other source whatever, . . . a tax of three per centum on the amount of such excess . . . above eight hundred dollars. . . ."

In this act the only provision for deductions is as follows:

> "Provided, That, in estimating said income, all national, state, or local taxes assessed upon the property, from which the income is derived, shall be first deducted."

Act of July 1st, 1862, 12 Stat. 432, 473:

> "SEC. 90. . . . That there shall be levied, collected, and paid annually, upon the annual gains, profits, or income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere or from any other source whatever . . . a duty of three per centum on the amount of such annual gains, profits, or income . . ."

In this act there is an almost identical provision to that above quoted from the act of 1861 for the deduction of taxes, and a new provision for the deduction of salaries of officers or persons in the service of the United States including senators, representatives and delegates,

and of interest, dividends, etc. on which tax has been paid at the source.

Act of June 30, 1864, 13 Stat. 223, 281:

> "Sec. 116. . . . That there shall be levied, collected, and paid annually upon the annual gains, profits, or income of every person residing within the United States . . . whether derived from any kind of property, rents, interests, dividends, salaries, or from any profession, trade, employment, or vocation, carried on in the United States or elsewhere, or from any other source whatever, except as hereinafter mentioned . . . a duty of five per centum on the excess over six hundred dollars . . . *And provided, further,* That net profits realized by sales of real estate purchased within the year for which income is estimated, shall be chargeable as income; and losses on sales of real estate purchased within the year, for which income is estimated, shall be deducted from the income of such year."
>
> "Sec. 117. . . . In estimating the annual gains, profits, or income of any person . . . there shall be included and assessed as part of the income of such person for each year . . . all income or gains derived from the purchase and sale of stocks or other property, real or personal, and the increased value of live stock, whether sold or on hand . . ."

In the Act of 1864 there is, in sec. 117, a further provision, similar in language to that in the Act of 1862, for the deduction of taxes, of official salaries, and of income tax paid at the source. A new provision is added for the deduction of rent of premises from which income is derived (p. 282) and of interest on encumbrances thereon, and the amount paid for ordinary repairs, and the provision follows, repeated in all the subsequent acts from that of 1865 to and including the Act of 1918:

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"But no deduction shall be made for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate."

Act of March 3, 1865, 13, Stat. 469, 479:

Sections 116 and 117 of the Act of 1864 were re-enacting (so far as pertinent) in substantially identical language with that above quoted.

Act of March 2, 1867, 14 Stat. 471, 477:

Section 116 of the Act of 1864 as amended by the Act of 1865 was further amended by striking out all after the enacting clause and inserting (478):

"That there shall be levied, collected, and paid annually upon the gains, profits, and income of every person residing in the United States . . . whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, carried on in the United States, or elsewhere, or from any other source whatever, a tax of five per centum. . . ."

Section 117 was amended by striking out all after the enacting clause and inserting:

"That in estimating the gains, profits, and income of any person, there shall be included all income derived from interest upon notes, bonds, and other securities of the United States; profits realized within the year from sales of real estate purchased within the year or within two years previous to the year for which income was estimated . . . the amount of all premium on gold and coupons; the amount of sales of live stock, sugar, wool . . . or other vegetable or other productions, being the growth or produce of the estate of such person . . . all other gains, profits, and income derived from any source whatever. . . . . And in addition to one thousand dollars exempt from in-

come tax, as hereinbefore provided, all . . . taxes . . . shall be deducted . . . losses actually sustained during the year arising from fires, shipwreck, or incurred in trade, and debts ascertained to be worthless, but excluding all estimated depreciation of values and losses within the year on sales of real estate purchased two years previous to the year for which income is estimated. . . . Provided that no deduction shall be made for any amount paid out for new buildings, permanent improvements or betterments, made to increase the value of any property or estate."

Appendix.

Debates in Congress, Acts of 1913 and 1916.

On *April 26, 1913*, the Income Tax Bill (H. R. 3321) was before the House of Representatives as Committee of the Whole House on the State of the Union. Cong. Rec., Vol. 50, pt. 1, Apl. 26, 1913. Mr. Hull (the reputed author of the income tax provisions) was explaining the bill in detail and with reference to the Sixteenth Amendment. At *page 513*:

> "*Mr. Hull.* I will say to the gentleman frankly that it has been held in construing all these laws that I have observed, that unless the unearned increment is expressly made income it is not considered income in any sense of the word but simply increase of value or capital. * * *
>
> *Mr. Mann.* What I really wanted to get at was not that, but whether it would relate back so as to cover all profit. Suppose a man bought property many years ago which probably last year was worth as much as it is this year. He sells it this year. What are his profits? How does he arrive at what his profits are?
>
> *Mr. Hull.* My judgment would be that as to an occasional purchase of real estate by one not a dealer or one making the buying and selling a business this bill would only apply to profits on sales where the land is purchased and sold during the same year.
>
> *Mr. Mann.* I hope that statement will remain in the *Record*."

and at *page 506*:

> "*Mr. Hull.* The rulings of the Treasury Department and the decisions of the courts of this country with respect to similar provisions of the old income tax laws and *also the English rules of construction*, all essential portions of which will be embraced in the Treasury regulations, will make clear the distinction between *taxable profits or income on the one hand and capital or principal on the other.*"

Appendix.

In the *Senate* debates over the Act of 1916 (H. R. Bill No. 16763) the following proceedings appear. On August 26th, 1916, the Senate resumed consideration of the House Bill. (Cong. Rec. Vol. 53, part 13, p. 13262).

In the bill as it passed the House the provision with respect to the basis of ascertaining gains on sales (now subd. (c) *supra,* p. 69) read as follows (p. 13262):

> "(c) Of the gain derived or loss sustained from the sale of real estate, stocks, bonds, securities, or other property, acquired before March 1, 1913, not bought and sold in the course of trade by the taxpayer, only such proportion shall be included as the time between March 1, 1913, and the date of sale bears to the entire time between the date of acquisition and the date of sale."

This provision was stricken out in the Senate without debate and the Senate Committee's amendment adopted, viz.:

> "(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such gain derived."

The Senate adopted as a further amendment the following proviso (page 13263, col. 2):

> "Provided, that for the purpose of ascertaining the amount of such loss or losses sustained in trade or speculative transactions not in trade from the same or any kind of property acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such loss or losses sustained."

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The following amendment was offered by the Senate Committee (page 13263):

> "Fifth. In transactions entered into for profit, but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom." (This amendment was adopted in conference and became part of the law.)

Here followed a long debate on the subject between Senators O'Gorman, Williams, McCumber and others in which the question of profits and losses on the sale of capital investments was not discussed but the debate was confined to speculative transactions and ordinary dealings, for example, on the stock market. Finally, the amendment to the amendment was agreed to in the following form:—

> "Fifth. In lawful business transactions entered into but not connected with his regular business or trade, the losses actually sustained therein during the year." (Cong. Rec., p. 13266.)

In the course of the debate above referred to, at page 13264, Senator Williams said:

> "Mr. President, the present law admits of no deductions whatsoever in these cases. We thought that was rather too drastic. These are transactions entered into for profit but not connected with the taxpayer's business or trade. It is intended to provide for speculative profits and speculative losses."

On August 30th, 1916, the debate on the bill (H. R. 16763, was resumed by the Senate as Committee on the Whole, Cong. Rec., Vol. 53, part 13, 64th Cong., 1st Sess., p. 13407) and Senator Clarke of Arkansas offered the following amendment:—

> (c) "For the purpose of ascertaining the gain derived from the sale or other disposition of real

property, the profits realized within the year from the sale or other disposition of any real estate purchased within two years previous to the close of the year for which such income is estimated, shall be the basis for determining the amount of such gain so derived from such sale or other disposition thereof."

Senator Williams, in behalf of the Committee in charge of the bill, then said:—

"With that amendment adopted there ought to be inserted the same amendment where the measure of losses sustained is to be considered because it involves the same question. I, therefore, ask unanimous consent that, if adopted, the same amendment shall be handed to the clerks at the desk by the Senator from Arkansas to be inserted at the other place in the bill where it would be relevant."

"Mr. Chamberlain: I should like to know the purpose of the amendment and why it is offered now after the committee amendment has been adopted."

"Mr. Clarke of Arkansas: I am very glad to explain it. The purpose of the amendment for which this has been substituted was to fix a date when the profits of an investment should cease to be income and become capital. The amendment adopted heretofore fixed March 1, 1913, as that date and made it a permanent date, so that no matter how long this Act might remain in force, that would be the date from which the investment as capital would be considered and all profits intervening would be income. This has been one of the troublesome questions in tax legislation. In 1867 Congress fixed the period within which real estate investments should be treated as income at two years. The matter was brought to the Supreme Court in the case of *Gray* vs. *Darlington*, Fifteenth Wallace, where it was held that profits during the current year were properly treated as income, that if the investment inured for a longer

period it became merged in capital and it was not proper to fix it as income. That feature was carried into the subsequent income tax law down to the one passed in 1894. The last income tax left it out entirely, so that the only part of the profit on real estate investment or any other investment for that matter, which should become profit for the purpose of being treated as income, would accrue within the current year. The purpose of this Act is to adopt as an approved rule two years as against real estate investments, that is to say, investments made in real estate and not consummated by a subsequent sale for a period greater than two years, shall be treated as no part of the income but are to be taken as a part of the loss and profit of that character of transaction and be permitted to pass as increased capital. If a sale occurred any time within the two years, the profit on the transaction would be treated as income and accounted for accordingly. It fixes a date that travels along with the law instead of fixing absolutely a day, which was the first of March, 1913. That would have involved the necessity of making an assessment every time an income-tax return was made with a view of determining whether or not in the meantime some profit had not attached to it. The one is a sensible, forcible rule and the other is an exceedingly inconvenient one which does not in all cases do justice because it might turn out that some investments would produce no profit whatever. No provision is made for taking care of that contingency."

"Mr. Hitchcock: According to what I heard of the amendment read, it differs from the amendment which the Senate adopted also in this respect that the amendment adopted by the Senate includes not only real estate but also personal and mixed property. I should like to know what becomes of the profit on personal or mixed property."

"Mr. Clarke of Arkansas: On personal property any profit made during the current year will be accounted for as income. Profit not made on that

character of property during the year or rather realized by the sale, would not be treated as income. That is the universal rule."

"Mr. Hitchcock: Is there any provision for that in the bill?"

"Mr. Clarke of Arkansas: The first section of the bill provides:

(a) That there shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual a citizen or resident of the United States, a tax of two percent upon such income.

That language was deemed sufficient in the case of *Gray* vs. *Darlington* and fixed the period of the annual accounting. If the Senator will permit me I will read the syllabus in that case which will make much clearer than I have been able to do, the point I am seeking to present to the Senate.

It is the case of *Gray* vs. *Darlington* reported in Fifteenth Wallace, page 63:

The advance in the value of personal property during a series of years does not constitute the gains, profits or income of any one particular year of the series although the entire amount of the advance be at one time turned into money by a sale of the property. Accordingly when bonds of the United States were sold by the owner, after being held by him four years, at an advance of Twenty thousand dollars over their cost to him, it was held that this amount was not taxable as 'gains, profits or income' for the owner for the year in which the sale was made under the Amendatory Internal Revenue Act of March 2, 1867 * * * At page 66 the Court said:

> The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital.

Appendix.

That is my answer to the inquiry of the Senator from Nebraska."

"Mr. Hitchcock: I still am not able to understand it. I will put a case to the Senator. Suppose a man has purchased in a certain year stocks or bonds and two years thereafter there is an advance of $20,000. Is the man just taxed for one year only on the profit made?"

"Mr. Clarke of Arkansas: He is not taxed at all on that because it ceases to be income and becomes capital."

"Mr. Hitchcock: What reason is there for taxing the man upon the profit he makes upon the sale of real estate within two years and not taxing him upon the profit he makes on the purchase and sale of securities?"

"Mr. Clarke of Arkansas: That always has been carried as a discrimination in the law. Whatever my opinion is it ought to be confined to the annual accounting. There is no necessity really for making a distinction against real estate but it always has been made and I thought it would be a preferable rule to the one the committee adopted."

"Mr. Williams: Real estate is not a live asset and is not generally bought and sold within one year."

"Mr. Hitchcock: I do not think that answers the question at all. Why should we exempt from the income tax the profit a man makes upon the purchase and sale of stocks and bonds? Why should they not be included with real estate just as they were originally included in this paragraph?"

"Mr. Clarke: They are included now if the purchase and sale is made within a year. That is the law. The Supreme Court of the United States answered that question and held that it is a part of his capital and a tax cannot be levied upon it."

"Mr. Hitchcock: I am at a loss to see why the increase in the value of real estate is not a part of the capital."

Appendix.

"Mr. Clarke of Arkansas: That matter may be decided some day and determined to the contrary, but at present the decision of the Supreme Court seems to treat it as a valid provision. There are numerous grounds upon which the distinction between real and personal property can be established where one rule of taxation applies in one case and another in another. Bonds pass very frequently and very rapidly, many times, whereas as the Senator from Mississippi suggests, that is not the rule in the case of real property."

"Mr. Hitchcock: It seems to me we are proposing to exempt from taxation some or most of the enormous profits made in this country. For instance during the last year or two perfectly prodigious incomes have been derived by men through successful speculation in the purchase and sale of stocks and bonds and the incomes derived from the purchase and sale of real estate are insignificant by comparison. I do not like to assent to exempting these profits while continuing to tax profits on real estate."

"Mr. Clarke of Arkansas: The Senator misunderstands me if he thinks I am trying to exempt their profits from taxation. I simply want to establish a rule that applies in every other character of taxation provided for in this bill and that is the annual accounting. That is what was done in this particular case. The tax collector in New York collected an income tax of $20,000 upon an increase on bonds that the taxpayer had been holding for four years. He paid the tax under a protest and sued the collector for it and that is the way this particular lawsuit was decided and like every other lawsuit will be decided— . . ."

"Mr. Chamberlain: I am frank to say I really do not understand the effect of this amendment. There was a good deal of discussion over this particular amendment, I will say to the Senator, and it involves two other amendments which I supposed, and those who think with me on the subject supposed, had been settled. This seems to change

the whole proposition and before it is acted upon I should like to have the matter go over until tomorrow, it involving three amendments as I suggested."

"Mr. Clarke of Arkansas: I have no objection to that course. The matter was submitted to the Senator from Alabama (Mr. Underwood) who proposed the amendment which is now offered as a substitute."

"Presiding Officer: Is there objection to postponing the consideration of this question until tomorrow?

"Mr. Williams: I have no objection, although I wish it could be disposed of now. The Senator from Alabama who drew the amendment which is upon the bill now has agreed to this amendment to the amendment. I think the amendment to the amendment helps the amendment itself very much but I have no objection to its going over.

"The Presiding Officer: If there is no objection, it will be postponed until tomorrow."

The subsequent debates in the Senate and the House of Representatives do not appear to throw any light upon the intention of Congress in regard to capital profits.

Supreme Court of the United States,

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH,

Plaintiff in error.

vs.

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York.

ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

REPLY BRIEF FOR PLAINTIFF IN ERROR.

SUPREME COURT OF THE UNITED STATES,

October Term, 1920.

No. 663.

David M. Goodrich,

Plaintiff in error,

vs.

William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York.

ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

REPLY BRIEF FOR PLAINTIFF IN ERROR.

I.

In considering the Income Tax Laws of the Civil War period as well as the Income Tax Act of August 28, 1894 (28 Stat. 509, c. 349, secs. 27 to 37), it must be borne in mind that these several statutes imposed not only taxes upon incomes derived from investments in real estate and personal property but also excise taxes on "any profession, trade, employment, or vocation carried on in the United States or elsewhere." It should further be borne in mind that a tax upon the *entire* proceeds of all sales of real or personal property of individuals not engaged in trade or business would be a direct property tax and not an excise (*Nicol* v. *Ames*, 173 U. S. 509, 521), whilst a tax on the carrying on of trade or business measured by the gross receipts resulting from all sales made in such trade or business would be a constitutional and valid

excise tax. *Pacific Insurançe Co.* v. *Soule*, 7 Wall. 433; *Spreckels Sugar Refining Co.* v. *McClain*, 192 U. S. 397, and *Flint* v. *Stone Tracy Co.*, 220 U. S. 107.

The tax levied by the Act of August 5, 1861 (12 Stat. 292, 309) was limited to "income". The more comprehensive phrase "gains, profits, or income" originated in the Act of July 1, 1862 (12 Stat. 473, c. 119) and was also employed in the Act of 1864 (13 Stat. 281, c. 173). The term "gains, profits *or* income" so introduced in the Act of 1862, became "gains, profits *and* income" in the Act of 1865 (13 Stat. 479, c. 78), and this formula was thereafter followed. The words "gains" and "profits" thus added in and by the Act of 1862 were presumably intended to add something to the scope and effect of the statute as theretofore worded. *Pennington* v. *Coxe*, 2 Cr. 33, 59. Obviously, if the term "income" had then been understood by Congress to include all gains and profits, no amendment would have been necessary. On the contrary, it is reasonable and logical to infer that, in adding the words "gains" and "profits", Congress meant to include something materially additional, and thereby to reach and tax gains or profits which would not necessarily be included within the scope of the term "income."

The idea of a differentiation between gains and profits resulting from trades or businesses and income resulting from investments in real and personal property may have been in the mind of the court in *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429; rehearing 158 U. S. 601 at p. 635, for Mr. Chief Justice Fuller then used the following language in reference to the Income Tax Act of 1894:

"We have considered the act only in respect of the tax on income derived from real estate, and from invested personal property, and have not commented on so much of it as bears on gains or profits from business, privileges, or employments, in view of the instances in which taxation on business, privileges, or employments has assumed the guise of an excise tax and been sustained as such."

Moreover, when the Sixteenth Amendment was formulated and submitted to the state legislatures for ratification the settled taxing formula had long been "gains, profits and income", and if it had been then intended by Congress to include all gains and profits resulting from the ownership of real and personal property, surely the form so long in use would naturally have been followed and the language not limited to "incomes". Indeed, less than a year prior to the submission to the state legislatures of the Sixteenth Amendment, Senator Owen introduced a joint resolution providing that—

"The Congress shall have power to provide for the collection of a uniform tax upon the gains, profits and income received by every citizen or person of the United States, including every corporation, association, or company doing business for profit in the United States, subject to such exemption as it may deem proper." (Cong. Rec., May 1, 1908, p. 5514.)

In the *Pollock* case, it was not contended by counsel for the taxpayer that a tax levied by Congress on gains and profits derived from the carrying on of businesses, privileges, employments, or vocations would be a direct tax. The essential difference between such an excise tax and a tax levied on income derived from investments in real estate and personal property was recognized and consistently urged throughout the argument in distin-

guishing the prior cases, such as *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433. This distinction was clearly confirmed by the court, and it has been reiterated by it in subsequent cases; e. g., *Spreckels Sugar Refining Co.* v. *McClain*, 192 U. S. 397, 411, 412, and *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 148.

In the brief now filed on behalf of the Government, comment is made upon the fact that the counsel in the *Pollock* case, in challenging the constitutionality of the Act of 1894, did not urge the contention now advanced, and it is suggested that apparently the point was not even thought of; but this assumption is hardly warranted by the record in that case.

The attention of the court was expressly called to the provision of the Act of 1894 which taxed "profits made upon the sale of land if purchased within two years" (157 U. S. at p. 444). The point was not then particularly urged because the controversy before the court did not involve any question whatever as to profits realized from the sale or conversion of investments in real or personal property. A perusal of the record will readily show this.

As to the rulings and decisions of the Treasury Department, it may suffice to point out that those prior to 1872 were not approved or followed in *Gray* v. *Darlington*, 15 Wall. 63, as shown in the plaintiff's main brief, and that those since 1913 are hardly entitled to be regarded as persuasive or authoritative in view of the repeated adjudications of this court overruling erroneous interpretations and assessments by the Commissioner of Internal Revenue under the Act of 1909. Indeed, in the brief now filed on behalf of the Government, it is stated (at p. 60) by the learned Solicitor General that after a

careful study of the Act of 1916 he is forced to the conclusion that the Commissioner of Internal Revenue has erroneously construed it in a very important respect materially affecting the rights of taxpayers. This erroneous construction has been insisted upon and applied uniformly by the Government during the past four years and large sums have been illegally collected thereunder.

Nor are the few and fugitive examples of state income taxes of any help. In state taxing legislation the present question is of no practical importance, and the difference between a direct and an indirect tax or excise, a property and an income tax, is of no particular constitutional significance. Under our state constitutions, it is immaterial what the incidences or measure of a tax may be, and it matters not whether a tax be a property tax, as distinguished from an income tax proper, or *vice versa*. In either aspect the power is not qualified by any such limitation as the Federal Constitution imposes on direct taxes. But in the case of a federal tax, the difference is controlling and decisive, for if the tax is in essence and effect a direct tax on property, as distinguished from a tax on incomes, it must be apportioned.

If what is essentially a direct tax because it takes a substantial part of the proceeds of the sale of a capital asset, can be changed in its nature by merely defining it as a tax on income, then part of the very purpose of the Constitution can be readily defeated and set aside, and the constitutional limitation and protection embodied in the requirement of apportionment will have to be regarded as in great measure illusory and futile notwithstanding the recent emphatic declaration of this court in *Eisner* v. *Macomber*, 252 U. S. 189, 206, that—

"A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overriden by Congress or disregarded by the courts."

It is submitted that the Sixteenth Amendment cannot be extended by loose construction beyond the clear import of the language or the subject matter of "incomes" specifically pointed out. *Gould* v. *Gould*, 245 U. S. 151, 153.

II.

The Government contends that the cases arising under the Corporation Excise Tax Act of 1909 necessarily involved a construction of the word "incomes" as used in the Sixteenth Amendment and that the word was used in that act "in exactly the same sense that it was used in the Sixteenth Amendment." This view is emphatically challenged by the plaintiff. It need only be repeated that the Act of 1909 was an excise tax and *not* a tax on incomes proper, and that the constitutional sense of the term "incomes" was not in any way involved because the measure of the corporation excise tax might have been receipts, gross or net, without affecting the validity of the statute as an excise tax. The court in the Corporation Excise Tax cases was called upon to do no more than determine the true intent and meaning of the language of the Act of 1909, and the result would have been exactly the same in each case if the

word "income" had not been used at all in the Act of 1909, but instead the words gains or profits, or net receipts had been employed. No question as to the intent and meaning of the constitutional term "taxes on incomes" as embodied in the Sixteenth Amendment was, therefore, presented for consideration or adjudication by the court. Stated in other words, had the Corporation Excise Tax of 1909 been measured by gross receipts, or the entire proceeds of the conversion of any capital assets into money, with or without profit, it would have been a valid excise tax and hence constitutional.

III.

In determining the true intent and meaning of the language "taxes on incomes" contained in the Sixteenth Amendment, the consequences of adopting the broad contention of the Government and holding, beyond the clear import of its language, that every increase of value in real estate and invested personal property when realized by sale or conversion becomes income now taxable without apportionment, must be duly weighed and appreciated. If it be now held that increase in value when so realized constitutes income within the Sixteenth Amendment, then constitutionally speaking there is no limit to the period or series of years during which the increase in value may have been accumulating or accruing. If the mere fact of sale or conversion can be logically held to change what was theretofore clearly capital into part capital and part income, then it matters not when the increased value accumulated or accrued, and Congress need make no concession whatever limiting the increase

to what accrued after the adoption of the amendment. It could then tax to an unlimited extent any increase realized by a taxpayer who had held property, real or personal, for many years, and could take, in a few years, it might well be, the greater part of all the accumulations of property in every State. The present annual tax, graduated up to 73 per cent. upon large incomes, demonstrates how readily and quickly most of the accumulated property of the citizens of the States might be then taken in federal taxes to the prejudice of the States and the impairment of their fiscal resources.

The vital importance of this question to the several States cannot be overstated, for it involves stupendous amounts of property investments and most of their present sources of taxation.

At all times during the thirty years preceding the ratification of the Sixteenth Amendment, the property values in the several States represented more or less recent increases or increment in value with corresponding increases in income. The appellant submits that it is highly improbable that in ratifying the Sixteenth Amendment the States contemplated and understood that the words "taxes on incomes, from whatever source derived," would operate to subject the greater part of the value of all the real estate or invested personal property within their limits to the unlimited taxing power of Congress. The extent of the property values which would thus be subjected to federal taxation without apportionment may be briefly reviewed.

The Census records report that the wealth of the United States increased from $43,642,000,000 in 1880 to $65,037,091,000 in 1890 and $187,739,071,000 in 1912;*

* Bulletin entitled "Estimated Valuation of National Wealth" published by the Department of Commerce, Bureau of the Census, in 1915.

that the assessed valuations of real property and improvements increased from $13,032,106,000 in 1880 to $18,956,556,000 in 1890 and $51,854,009,000 in 1912*, and that the money income of the United States increased from $7,382,340,000 in 1880 to $12,062,520,000 in 1890 and $30,481,920,000 in 1910.**

In determining these questions as to the taxing power of Congress, it is, of course, particularly fitting and proper to bear in mind the underlying theory and essential nature of our federal system, why the provisions limiting Congress to apportionment in respect of essentially direct taxes were adopted, and how vitally the interests of the States would be affected, if not prejudiced, and their taxing resources impaired by a ruling that every increase in value of real estate or invested personal property whenever realized by the owners thereof would be subject to the unlimited taxing power of the Federal Government exercisable by means or in the guise of a tax on incomes.

This aspect was pointed out by Mr. Chief Justice Fuller in the *Pollock* case as follows (158 U. S. at page 621):

> "The founders anticipated that the expenditures of the States, their counties, cities, and towns, would chiefly be met by direct taxation on accumulated property, while they expected that those of the Federal Government would be for the most part met by indirect taxes. And in order that the power of direct taxation by the general government should not be exercised, except on necessity; and, when the necessity arose, should be so exercised as to leave the States at liberty to discharge their respective obligations, and should

*Bulletin entitled "Wealth, Debt and Taxation" published by the Department of Commerce, Bureau of the Census, in 1915.

**Report of the Royal Statistical Society, London, of July, 1919. Estimates based upon publications of the Bureau of the Census, in 1912.

> not be so exercised, unfairly and discriminatingly, as to particular States or otherwise, by a mere majority vote, possibly of those whose constituents were intentionally not subjected to any part of the burden, the qualified grant was made. Those who made it knew that the power to tax involved the power to destroy, and that, in the language of Chief Justice Marshall in *McCulloch* v. *Maryland*, 'the only security against the abuse of this power is found in the structure of the government itself. In imposing a tax, the legislature acts upon its constituents. This is, in general, a sufficient security against erroneous and oppressive taxation.' 4 Wheat. 428. And they retained this security by providing that direct taxation and representation in the lower house of Congress should be adjusted on the same measure."

The security and protection which the States thus stipulated for in respect of direct taxes would be greatly impaired if it be now held that the increase in value of real or personal property in the States is subject to unlimited federal taxation by means of a tax on incomes. It is submitted that no such power was intended to be conferred by the phrase "taxes on incomes" as used in the Sixteenth Amendment, and that the intent and purpose of that Amendment can be fully and reasonably effectuated by limiting it to the current meaning and common understanding of the word income, namely, the usual and periodical return or benefit resulting from the ownership of real or personal property, which would not include the extraordinary, casual, or exceptional gain or profit realized from the conversion of a capital asset or investment into money.

Conclusion.

The Sixteenth Amendment and the Act of 1916 should, therefore, be construed as not applying to the increase in value of an investment in real or personal property realized upon the conversion of such investment into money in pursuance of isolated transactions not connected with the taxpayer's trade or business.

Washington, D. C., March 9, 1921.

William D. Guthrie,
Langdon P. Marvin,
Henry M. Ward,
Herbert Pope,
Rush C. Butler,
Of counsel for plaintiff in error.

Supreme Court of the United States.

October Term, 1920.

No. 663.

David M. Goodrich,
Plaintiff in error,

v.

William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York.

Writ of error to the District Court of the United States for the Southern District of New York.

Motion to advance by Plaintiff in error.

Langdon P. Marvin,
Counsel for Plaintiff in error.

Supreme Court of the United States

OCTOBER TERM, 1920,

No. 663.

DAVID M. GOODRICH, Plaintiff-in-error, *against* WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York.	Motion to advance by Plaintiff-in-Error.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

Now comes David M. Goodrich, the plaintiff-in-error herein, and respectfully moves that the above entitled cause be advanced for early hearing during the present term of this Court.

The writ of error herein presents to the Court for review a final judgment rendered on the 17th day of December, 1920, sustaining a demurrer to a complaint upon the ground of insufficiency. The action was brought to recover moneys paid under

protest upon the ground that they had been illegally exacted by the defendant-in-error under color of a tax unlawfully imposed upon the plaintiff-in-error.

This is the cause referred to in the brief of the plaintiff-in-error, and on the oral argument of his counsel, in *Eldorado Coal & Mining Co.* v. *Mager*, No. 609, which was argued immediately following *Merchants Loan & Trust Co.* v. *Smietanka*, No. 608, on the 12th day of January, 1921. The case of *Goodrich* v. *Edwards*, No. 663, presents questions similar to those involved in the two cases mentioned, viz.:

1. The constitutionality of so much of the Income Tax Law of 1916 as has been construed to tax as income capital increment realized upon the conversion of capital investments into cash after the passage of said Act; and

2. The correctness of the construction given to said Act of Congress.

These questions, however, are presented in the present case with respect to the sale of investments of an individual investor, while in *Merchants' Loan & Trust Co.* v. *Smietanka*, No. 608, the questions arose with respect to the sale of investments held by a trustee, and in *Eldorado Coal & Mining Co.* v. *Mager*, No. 609, the questions were presented with respect to the sale of the property of a corporation in the process of winding up its business.

The three cases, therefore, whilst involving somewhat different transactions, complete a cycle of typical cases presenting to the court these questions from the several different points of view. It had been hoped to argue the present case at the same time as the two other cases men-

tioned, but since that became impracticable, it is suggested that the argument of the present case might well be advanced for an early hearing.

The present case further involves two additional and far-reaching questions not involved in the other two cases, viz.:

3. Whether the proceeds derived from the sale of property acquired by gift or bequest are taxable as income; and

4. Whether, where property has been acquired for investment prior to the 1st day of March, 1913, and sold while the Income Tax Act of 1916 was in force at an actual loss to the investor, the difference between the market value of the property on the 1st day of March, 1913, (when less than the value at the time of acquisition) and the price realized upon the sale, represents income and is taxable as such.

It is respectfully submitted that it is in the public interest that these important questions should also be authoritatively determined and settled at the earliest convenience of the court.

As to the first two points mentioned above, the courts of first instance have arrived at conflicting results. The District Court for the District of Connecticut has held the statute to be unconstitutional in the respect involved herein in the case of *Brewster* v. *Walsh*, decided on the 16th day of December, 1920 (copies of the opinion of Judge Thomas in that action having been submitted to the court on the argument of *Eldorado Coal & Mining Co.* v. *Mager*, No. 609), and rulings to the contrary were made in the case at bar and by the District Court of the United States for the Northern District of Illinois in the other two cases above mentioned.

Wherefore, the plaintiff-in-error respectfully prays this Honorable Court to advance the above entitled cause for early hearing during the present term.

All of which, as in duty bound, is respectfully submitted for the consideration and action of the court.

Notice of this application has been served on the Department of Justice, and the Solicitor General has authorized the statement that he does not object to this motion.

January 24, 1921.

Langdon P. Marvin,
Counsel for plaintiff-in-error.

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH,

Plaintiff-in-Error,

vs.

WILLIAM H. EDWARDS, UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF THE STATE OF NEW YORK.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

PETITION FOR REHEARING IN BEHALF OF PLAINTIFF-IN-ERROR.

LANGDON P. MARVIN,
HENRY M. WARD,
Of Counsel for Plaintiff-in-Error.

Supreme Court of the United States.

October Term, 1920.

No. 663.

David M. Goodrich,
Plaintiff-in-error,

vs.

William H. Edwards, United States Collector of Internal Revenue for the Second District of the State of New York.

In error to the District Court of the United States for the Southern District of New York.

PETITION FOR REHEARING IN BEHALF OF PLAINTIFF-IN-ERROR.

Now comes David M. Goodrich, the plaintiff-in-error herein, and respectfully petitions this honorable court for a rehearing of the above entitled cause, for the reasons hereinafter stated.

This cause was argued on March 10th and 11th, 1921, together with the case of *Walsh* v. *Brewster*, No. 742; and the cases of *Merchants' Loan & Trust Company* v.

Smietanka, No. 608, and *Eldorado Coal & Mining Company* v. *Mager*, No. 609, involving similar questions, were argued on January 11th and 12th, 1921. All four cases were decided by this Court on the same day, March 28th, 1921. All of the questions involved were decided in favor of the government, excepting that in the Goodrich and Brewster cases the Court held that where no gain accrued to the taxpayer on the sale in 1916 of an investment acquired before March 1st, 1913, no tax can be imposed on the fictitious profit arising from the receipt on such sale of a sum greater than the market value of the investment on March 1st, 1913. With this exception, the Court held that the Income Tax Act of 1916 intended to tax the increment of capital value when realized in cash by the sale of an investment and that the Act so construed is not unconstitutional.

Similar questions under the Income Tax Act of 1918 arise in the case of *Darlington* v. *Mager*, No. 716, which the Court advanced for argument on April 11th, 1921, prior to the decision of the above mentioned cases.

It is respectfully submitted that in its decision of these cases the Court has overlooked certain considerations which have an important and perhaps controlling bearing on the questions involved and that for these reasons a rehearing of this cause is desirable in the interest of the millions of taxpayers and thus of the Government itself.

We respectfully refer to the brief and reply brief heretofore submitted on behalf of the plaintiff-in-error, and to the brief of Hon. T. P. Gore and Hon. Hoke Smith, filed as *amici curiae*, for a more full statement of the questions involved in this petition; and also to the considerations presented in petitions for rehearing submitted in Nos. 608, 609 and 742, which, in order to avoid repetition, we beg leave to incorporate and adopt in this petition.

In addition to the aforesaid considerations, we briefly state the following grounds for this petition and the relief sought thereby:

1. In its opinions in these cases, the Court, after quoting section 2 (a) of the act of September 8, 1916, has assumed without further consideration that the act includes the increment of value derived from the sale of an investment as a taxable item.

We respectfully refer the Court to Point III and the appendix of the brief heretofore filed in behalf of the plaintiff-in-error, and also to his reply brief, to the effect that the Income Tax Law of 1916, analyzed and construed in the light of circumstances existing when it was enacted and the understanding of Congress, was not intended to tax profits received on the sale of an investment. The Solicitor General has conceded that the Act of 1913 was not so intended (as appears from his brief, page 28, in the *Merchants' Loan & Trust Co.* case, No. 608, and from his brief, page 6, in the *Goodrich* case, No. 663), and it is submitted that *Lynch* v. *Turrish*, 247 U. S. 221, so determined, for under the doctrine laid down in *Lynch* v. *Hornby*, 247 U. S. 339, the increment under consideration in the *Turrish* case was taxable even though it accrued prior to March 1st, 1913. It is respectfully submitted that the Court in this respect in its opinions in the present cases overlooked this consideration. And if this increment was not taxable under the 1913 Act it was not taxable under the 1916 Act, as is recognized from the opinion of the Court in the *Merchants' Loan & Trust Co. case* (No. 608) in which the Court stated:

> "There can be no doubt that the word (income) must be given the same meaning and content in the Income Tax Acts of 1916 and 1917 that it had in the Act of 1913."

This question of the proper construction of the 1916 Act was, owing to lack of time, not fully argued in the present case, and it is respectfullly submitted that, in so vital a matter, an opportunity for a reargument would be beneficial and advisable from every point of view.

2. On the question of the construction of the Sixteenth Amendment to the Constitution of the United States, the Court has adopted as its definition of the word "incomes" the definition previously formulated in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415 (decided in 1913), and in *Eisner* v. *Macomber*, 252 U. S. 189, 207 (decided in 1920). Yet in the former case the Court was defining the word "income" in the Corporation Excise Tax Act of August 5, 1909, under which, as heretofore pointed out in the plaintiff-in-error's brief, totally different considerations were involved; and in the latter case the definition was not essential to the determination of the case, was not, therefore, fully considered in the submission of the case, and resulted from a concession by counsel of a point not involved in the case.

We submit that the true definition of the word "incomes" in the Sixteenth Amendment is that expressed in the opinions of the Courts rendered before the adoption of the amendment and understood by Congress when framing it and by the States when accepting it—notably *Gray* v. *Darlington*, 15 Wall. 63 (1872), the English decisions and the opinions of the State courts defining the respective rights of life tenants and remaindermen under trusts—rather than that evolved in opinions rendered after the adoption of the amendment: and that the earlier meaning became embodied in and an unseverable part of the Sixteenth Amendment.

3. It appears from the opinion of the Court in the *Merchants' Loan & Trust Co.* case (No. 608), adopted in the other three cases, that counsel in the briefs and oral

arguments in the four cases decided on March 28th must have created a misapprehension in the mind of the Court with respect to the distinction they sought to make between profits accruing to a trader in the course of his business and those resulting from the sale of an investment, for the Court (p. 6) refers to the argument "that the word 'income' as used in the Sixteenth Amendment and in the Income Tax Act we are considering does not include the gain from capital realized by a single isolated sale of property but that only the profits realized from sales by one engaged in buying and selling as a business —a merchant, a real estate agent, or broker—constitute income which may be taxed," and further says "that there is no essential difference in the nature of the transaction or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction or one of many."

The distinction which counsel sought to make was not based in any particular on this ground, and the phrase "isolated transaction" was adopted from the ruling of the Treasury Department (T. D. 2090, Dec. 14, 1914) merely as a convenient phrase to differentiate the occasional sale of an investor from the constant buying and selling of a trader who depends on his transactions for his livelihood.

Whether the transactions involved are one or many makes no difference, excepting in so far as constant sales might be held to convert an investor into the class of traders. But the distinction between sales by a trader and by an investor has been recognized for almost a century under the British Income Tax Acts, and in many other respects, including all of the Income Tax laws of this country. It is an inherent difference so ingrained in the mind through many years that it must be considered as having been before the framers of the Sixteenth Amendment and of the Income Tax Acts.

In the briefs heretofore submitted in the four cases determined on March 28th and in the petitions for reargument to be submitted in the other three cases, this distinction has been pointed out, and we adopt the considerations therein expressed. We also beg to call the attention of the Court to this further consideration which may throw some light on what we believe to be a fundamental difference.

Realized increment of value such as is involved in this case is not the basis for the taxation of income in the hands of a merchant or trader any more than it is in the hands of an investor; and the contention that there is no essential or fundamental difference between the two cases and that increase in value realized by an investor is income because increase in value realized by a trader is income is inapplicable.

The business profits of a merchant have only the remotest sort of relationship to realized increase in value. Whether the merchant makes a profit in any one transaction or in a series of transactions does not depend on increase in value in the property in which he trades, but on his ability to obtain a higher price for the goods on selling than he paid for them on buying. The profit is the result of the successful conduct of the business—buying in one market and selling in another, buying at wholesale and selling at retail, buying raw material and selling the finished product, underwriting an issue of bonds and selling them in small lots at an advance. In all of these cases increment of value, if it enters in at all, is a negligible element in the business profit and the profit may accrue where values as represented in their cash equivalent have fallen.

Under the Income Tax Acts a merchant or trader is not taxed, at least directly, on any realized increase in value of one article or of a thousand articles. In his return he is required first to state the amount of his *total*

sales and income from business or professional services. From this he deducts the cost of goods sold (including labor, material and supplies, merchandise bought for sale, other costs, plus an inventory at the beginning of the year and less an inventory at the end of the year; salaries and wages; rent on the business property; interest on business indebtedness to others; taxes on business and business property, repairs, wear and tear, obsolescence, depletion, and property losses; amortization of war facilities; bad debts arising from sales or professional services; and other expenses. The net income from his business or profession is then carried into the income on which he is taxed.

This net income has only the remotest relationship to any realized increase in value of any of the commodities bought and sold by the merchant. Of course in certain transactions there may have been an increase in value which was eventually reflected in the net income, but any increase of value realized by a trader on any one or more transactions is not and never has been the basis for ascertaining the income upon which he is taxed. That basis is the *total receipts* from his sales, less his cost of goods and business expenses.

If there is "no essential difference in the nature of the transaction or in the relation of the profit to the capital involved" with respect to increase in value realized by an investor from that realized by a trader, then the increase in value realized by an investor is not taxable income because it is not, as such, taxable income when realized by a trader. The decision of the Court in the cases now under consideration, holding that an increase in value realized by an investor is taxable income, thus discriminates against the investor and imposes a tax on him on his total realized increase in value where no such tax is imposed on the trader or merchant.

The distinction between the net annual profits of a merchant or trader and the increase in value of an investment realized by an investor is fundamental and has, it is submitted, always been recognized by the courts until the present decisions; it has always been held that the former is income and that the latter is merely an increase in principal. This doctrine was recognized in *Gray* v. *Darlington*, 15 Wall. 63, approved in *Lynch* v. *Turrish*, 247 U. S. 221; the English cases have always made the distinction; and in all jurisdictions where the respective rights of life tenant and remaindermen under trusts have been under consideration the realized increase in value of an investment has always been held to be principal. Where a trustee has invested in 100 shares of stock for $10,000. and in ten years sells them for $100,000, no court would hold that the difference of $90,000. can be distributed among the life tenants. It is increase of the capital for reinvestment for the ultimate remainderman. On the other hand, where a banking business has been bequeathed to a trustee, who has been directed to continue it and who in the first year, through the buying and selling of stocks and bonds makes a profit of $90,000., no court holds that that is part of the capital which passes to the remainderman; it is clearly income which must be distributed among the life tenants. (*Thorn* v. *De Breteuil*, 179 N. Y. 64) This clearly illustrates the absolute, essential and fundamental distinction between profits realized by an individual on the sale of an investment and the profits made in any business, the result of the difference between the gross receipts and the losses and expenses and other charges of the business.

A further fundamental difference between traders and investors, apparently overlooked by the Court and not referred to in arguments, oral or written, heretofore submitted, is that with respect to the trader a mere appreciation or increment of value in the property in

which he trades, not realized by sale, is an item of his taxable income and therefore taxed, under the system of inventories approved and enforced for many years, while in the case of an investor it is settled by the present decisions as well as by all the recent decisions in point, that unrealized increment of value in capital investments is neither taxed nor taxable.

The present decision holding that increase of value realized by an investor is income discriminates against the investor, since on the same state of facts the merchant or trader is not taxed. The distinction between the net annual profits of a trader and the realized increase of value of an investor was not apparently made clear to the Court, and the opportunity for a full reargument of the question is earnestly desired.

4. The effect of the present decisions of this Court, as expressed in its opinion in the *Merchants' Loan & Trust Co.* case, upon the respective rights of life tenants and remaindermen in trusts will certainly be confusing and may be startling. If a profit like that involved in such case is income for the purpose of taxation, why is it not likewise income to be paid over to the life beneficiary? Undoubtedly the present decision will be quoted to that effect, and if followed will overturn the settled law of all jurisdictions.

It is respectfully submitted that the statement of the Court, that "the opinions of the courts in dealing with the rights of life tenants and remaindermen in gains derived from invested capital, especially in dividends paid by corporations, are of little value in determining such a question as we have here, influenced as such decisions are by the terms of the instruments creating the trusts involved and by the various rules adopted in the various jurisdictions for attaining results thought to be equitable" (p. 7), scarcely meets the argument based on such decisions. In the simple case where property

is left in trust to pay the income to A for life and on his death the principal to B, without further direction, it has always been held that a profit accruing through the sale of an investment is principal and must be reinvested. Is this principle of law overruled by the present decisions of this Court? Certainly those decisions will tend to unsettle the rule, if not to overrule it; and if the $700,000 profit considered in the *Merchants' Loan & Trust Co.* case is taxable income the trustee might well be compelled by the life tenant (apart from the specific provisions of that trust instrument) to pay it over to her.

The doubt created by the present decisions should, we submit, be resolved on a reargument of this cause.

5. In its opinion in the *Merchants' Loan & Trust Co.* case, the Court has briefly dismissed the British income tax decisions as "interpretations of statutes so wholly different in their wording from the acts of Congress which we are considering that they are quite without value in arriving at the construction of the laws here involved."

Yet since 1799, except for the period from 1816 to 1842, England has had income taxes,* and at least since 1842 these taxes have been imposed on "the annual Profits or Gains arising or accruing to any person" (see 5 & 6 Vict. c. 35, 1842, p. 238; 16, 17 Vict. c. 3452, 1853). The words "annual profits or gains" in our Income Tax Laws were doubtless taken from these British Acts, and the uniform line of authorities (quoted in the plaintiff-in-error's main brief at pages 30 to 35) in England and in the British Colonies, holding that these words do not include the profit or increment of value when realized in cash on the sale of an investment, are surely pertinent in the construction of an Act of Congress adopted with

* Encyclopaedia of the Laws of England, 2nd ed., Vol. VII, p. 60.

this settled definition before it and, as shown by the debates, fully known to Congress. It is surely no presumption to say that both the Sixteenth Amendment and the Income Tax Acts were framed in the light of the British precedents, and as stated by this Court, "that Congress, in adopting the language of the English act, had in mind the constructions given to these words by the English courts, and intended to incorporate them into the statute" (*Interstate Commerce Com.* v. *B. & O. R. R.*, 145 U. S. 263, 284; see also *Interstate Commerce Com.* v. *Del., L. & W. R. R.*, 220 U. S. 235, 253-4; *McDonald* v. *Hovey*, 110 U. S. 619, 628).

Thus, we submit, the British decisions were entirely pertinent in the construction of the Sixteenth Amendment and of the Income Tax Acts, and if, through failure to make this clear to the Court, those decisions were not given full consideration and the weight to which they are entitled, we respectfully ask for the opportunity to reargue this point.

6. The effect of the present decisions is, we believe, to overrule *Gray* v. *Darlington*, 15 Wall. 63, and *Lynch* v. *Turrish*, 247 U. S. 221.

It does not seem to us that the former case can be limited to the terminology of the 1867 Act. The Court in its opinion certainly makes no such limitation. If it had intended to tax the income of the year in which the gain accrued and was received, it could have directed an apportionment of the profits, but no such opinion was expressed. The Court clearly laid down the general doctrine that such profits on the sale of an investment are not income at all, but an increase of capital, saying (at p. 66):

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in

> value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital."

And in *Lynch* v. *Turrish* this Court said of the *Darlington* case (at p. 230):

> "This case has not been since questioned or modified."

And further:

> "Indeed, the case decides that such advance in value, is not income at all, but merely increase of capital and not subject to a tax as income."

And while the advance in value in the *Turrish* case accrued prior to March 1st, 1913, the decision of the Court, we submit, was not based on that consideration and in view of the decision made on the same day in *Lynch* v. *Hornby*, to the effect that dividends declared after that date were taxable income even though earned prior thereto, could not consistently have been so based.

Does the Court intend to overrule *Gray* v. *Darlington* and *Lynch* v. *Turrish* in favor of the definition adopted in two cases where the question was quite different or not involved at all?

The opinion of the Court in the *Merchants' Loan & Trust Co.* case dismisses *Gray* v. *Darlington* and *Lynch* v. *Turrish* with only a brief reference, but the effect of the decision is, we submit, to overrule those cases. Yet the doctrine of *Gray* v. *Darlington* has been regarded as the settled law of the land for nearly half a century and was fully appreciated and understood by Congress when the Sixteenth Amendment was adopted, as well as when the Acts of 1913 and of 1916 were under consideration (Appendix to plain..iff-in-error's brief, p. 83). What the

meaning of the word "incomes" in that Amendment is must surely be gauged by the construction given to it by this Court and by common usage prior to and at the time of the adoption of the amendment rather than by any definition evolved in cases decided after the Amendment to the Constitution had been declared in effect.

In *Gray* v. *Darlington* this Court solemnly declared that realized advance in value does not constitute gain, profits or income, but does constitute merely increase of capital. That meaning of the word "income" was the recognized meaning of the word when the Sixteenth Amendment was adopted. Therefore, when the word "incomes" was used in the Amendment it had that meaning and could have no other meaning, and no subsequent definition of the word can affect the situation.

We earnestly ask the opportunity to reargue this question.

For these reasons, and for the additional reasons stated in the petitions for rehearing submitted in numbers 608, 609 and 742, and in the brief and oral argument in the case of *Darlington* v. *Mager*, No. 716, the plaintiff-in-error respectfully petitions this Court that an order may be made for a rehearing in this cause on a day to be appointed by this court and upon such points as the Court may direct.

The undersigned members of the bar of this Honorable Court and of counsel for the petitioner certify that, in their opinion, it is eminently proper that this writ of error should be reheard and reconsidered by this Court and that this petition is well founded in point of law and is presented in good faith and in the conviction that the

questions involved in this cause, of such moment to the citizens of this country, should be presented to this Court fully and completely on a rehearing of this cause.

David M. Goodrich,
Plaintiff-in-Error,
by Langdon P. Marvin,
Henry M. Ward,
of Counsel.

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Authorities Cited.

In the Supreme Court of the United States.

OCTOBER TERM, 1920.

DAVID M. GOODRICH, PLAINTIFF IN ERROR, *v.* WILLIAM H. EDWARDS, UNITED STATES Collector of Internal Revenue for the Second District of the State of New York.	No. 663.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR THE DEFENDANT IN ERROR.

This case is here on writ of error to review the action of the District Court in sustaining a demurrer and dismissing the suit of the plaintiff in error brought to recover certain income taxes for the year 1916 paid under protest.

THE FACTS.

Two items of income which the plaintiff in error was required to include in his return and upon which he paid taxes are involved.

1. In 1912 he purchased 1,000 shares of the capital stock of a mining company at 50 cents per share, paying in all \$500. On March 1, 1913, the stock had advanced in price until it was worth 69½ cents per share, or \$695. He held it, however,

until 1916, when it was worth more than $13 a share, and sold it for $13,931.22. As a result, the Commissioner of Internal Revenue required him to report an item of income equal to the difference between the selling price and $695, its value on March 1, 1913, or $13,236.22.

2. Prior to 1912 he was the owner of certain shares of stock in the B. F. Goodrich Company, a corporation of the State of Ohio, which he had previously received by gift and bequest from his mother. In 1912 this Ohio company transferred its business and assets to a new corporation of the same name organized under the laws of New York. The plaintiff in error exchanged his shares of stock in the Ohio company and received in return cash and shares of stock in the New York corporation. At that time the fair market value of the shares in the New York corporation was $81 per share, making the value of 3,600 shares received by plaintiff in error $291,600. On March 1, 1913, however, their value was only about $41.25 per share, or $148,635.50. Subsequently they increased in price until they were sold in 1916 for $269,346.25. This was $22,253.75 less than their value in 1912 but $120,710.75 more than their value on March 1, 1913. He was required to report this latter amount as an item of taxable income.

STATUTE INVOLVED.

The taxes in question were collected under the provisions of the act of September 8, 1916 (39 Stat., c. 463, p. 756), as amended by the act of October 3,

1917 (40 Stat., c. 63, p. 300). Section 1 (a) and (b) of the act of 1916 levied certain income taxes to be paid annually upon the entire net income received in the preceding calendar year from all sources by every individual a citizen or resident of the United States. This was amended by the act of 1917 only with respect to the rate of taxation.

Section 2 (a) defines net income of taxable persons as follows:

> That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership, or use of or interest in real or personal property, also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: * * *.

And section 2 (c) contains a specific provision for ascertaining the gain derived from a sale of property, acquired prior to March 1, 1913, as follows:

> For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen

hundred and thirteen, shall be the basis for determining the amount of such gain derived.

QUESTIONS INVOLVED.

(1) The fundamental contention of the plaintiff in error is that the proceeds of the sale of capital assets do not, in any event, include anything which Congress has the power to treat as income for purposes of taxation.

(2) With respect to the second item mentioned above, the plaintiff in error contends that, even if mistaken in his principal contention, there is no income in the case of a sale of stocks at less than their cost but more than their value on March 1, 1913, since, in that case, the whole transaction shows a loss and not a gain.

BRIEF.

I.

Reference to the Government's brief in Merchants Loan & Trust Company v. Smietanka, No. 608, at the present term.

Except for the question raised by the second contention above stated, the question involved in this case is the same question involved in *Merchants Loan & Trust Company* v. *Smietanka*, No. 608, which was argued in January and is under consideration by the court. To avoid repetition, the attention of the court is again called to the Government's brief in that case and to the argument there made in support of the following propositions:

1. The acts of Congress expressly include in taxable income gains, or profits derived from "sales" of real

or personal property. The intention, therefore, to tax income derived from the conversion of capital assets is clear.

2. Giving effect to the rule that the word "income" as used in the sixteenth amendment and in the acts of Congress is to be understood as it is understood in common speech, this court has said that—

> "income" may be defined as the gain derived from capital, from labor, or from both combined. (*Stratton's Independence (Ltd.)* v. *Howbert*, 231 U. S. 399, 415.)

And repeating this definition in the late case of *Eisner* v. *Macomber* (252 U. S. 189, 207), Mr. Justice Pitney expressly construed it to include profits derived from the profitable sale of capital assets by adding:

> provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* case.

3. This court has emphatically rejected the contention that the entire proceeds of the conversion of capital assets shall be treated as the same capital, changed only in form and containing no element of income, although including an increment of value, and has expressly held that, while conversion of capital assets does not always produce income, but that, when the selling price is less than cost, the result is a loss or outgo—

> Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the "gross income"

received "from all sources." (*Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185.)

4. A mere increase in value, while it remains such, is not income. In order that it may become income, something must be done to segregate it from capital so that the owner may use it or dispose of it without using or disposing of the capital to which it is an incident. This something, however, is done when the capital asset is converted into cash, so that the increment of value or profit may be withdrawn and leave the capital intact.

5. The word "income," as used to describe the thing upon which the present act imposes a tax, means, necessarily, the same as the word "income" by which in the act of 1909 the corporation excise tax was to be measured. As used in the latter act, the administrative branch of the Government has, from the beginning, construed it as including gains derived from the profitable sale of capital assets. This construction has uniformly received the approval of this court, and, under it, millions of dollars of taxes have been collected.

6. *Gray* v. *Darlington* (15 Wall. 63), is not applicable to the present controversy. This court held in *Hays* v. *Gauley Mountain Coal Co.* (247 U. S. 189), that it was not controlling in a case arising under the act of 1909 because that act measured the tax by the income *received* during the taxable year. True, in *Lynch* v. *Turrish* (247 U. S. 221), it was said that *Gray* v. *Darlington* could not be distinguished from a case arising under the act of 1913, which levied a tax upon income *arising or accruing* during the

taxable year. The present act, however, goes back to the language of the act of 1909 and imposes the tax upon income *received* during the taxable year.

For the full argument in support of these propositions, reference is made to the Government's brief in No. 608, and the present brief, avoiding, as much as possible, repetition, will be directed to replying specifically to the arguments now advanced in this case.

II.

Prior to the adoption of the sixteenth amendment, the word "income," as understood by the legislative, the executive, and the judicial branches of the Government, included gains or profits derived from the sale of capital assets.

It is, of course, conceded that the sixteenth amendment gave no new meaning to the word "income." It merely dealt with the power of Congress to tax incomes, assuming that the word "income" had a well-understood meaning. This was no mistaken assumption. All branches of the Government had, during a period of many years, dealt with the subject of incomes. A review of these dealings shows that no department of the Government had ever entertained any doubt that gains resulting from the profitable sale of capital assets were included in the term "income" as generally understood. There had been some differences of opinion as to the extent to which such gains should be taxed, with particular reference to the period during which they had accrued; but that they, in fact, constituted income has never until recently been doubted.

In 1861 Congress imposed a tax on "annual income." (12 Stat., c. 45, p. 292.) This act, however, was never put into effect. (Seligman, Income Tax, p. 435.) The act of July 1, 1862 (12 Stat., c. 119, pp. 432, 473), imposed a tax to be paid annually upon "annual gains, profits, or income," making no specific mention, however, of gains from the sale of capital assets. The Commissioner of Internal Revenue ruled that profits from the sale of real estate were to be considered income irrespective of the time when the property had been purchased. (The Cong. Globe, May 27, 1864, p. 2516.) Because of this interpretation put upon the law, the propriety of taxing such gains which had accrued during a period of years, and before the enactment of the income tax law, became the subject of discussion in Congress when the income tax law of 1864 was under consideration. That such gains constituted income was not questioned, except perhaps as to that portion which had accrued during prior years, and the justice of a tax on that portion of the gains was sharply called in question. The committee having the bill in charge, to meet this injustice, proposed the following:

> *And provided further*, That net profits realized by sales of property upon investments made within the year, for which income is estimated, shall be chargeable as income; and losses on sales of property purchased within the year, for which income is estimated, shall be deducted from the income of such year. (Cong. Globe, p. 2516.)

This was plainly predicated upon the recognized fact that gains derived from the sale of property purchased as an investment constituted income. But the committee thought that the tax should be levied only in cases where the investment and the sale were made during the same year. In explaining the committee's action, Senator Fessenden, after stating that the commissioner had ruled that, where a man purchased land and held it for a period of years and sold it in any given year, he must account for, as income of the year, the profit over and above the cost, making allowance for taxes, interest, etc., said:

> That was the construction the commissioner put upon it in writing. Our difficulty was to fix any ratio of income. If anything could be considered as income in such case, it is the increase of value for the year. If, for instance, you buy property one year and hold it, and by last year's accumulation on it it became so much more valuable, that might be considered as income when you sold it; but how could you tell very readily what that was? The committee, therefore, in considering the question and looking into the difficulties that surrounded it, came to the conclusion that the only mode in which it could be arranged—and it should certainly be fixed in some way—was to provide that if a person sells property of any sort within the year you may estimate the increased value, what he made upon the transaction, as income; but certainly it should not apply to purchases existing before we ever thought of passing an income tax or internal revenue tax.

> We fixed it in that way, coming to the conclusion that that was the only reasonable mode in which to fix it, and trusting that if the House differed with us in opinion they would enable us to establish some other rule that would be better than ours. (Cong. Globe, pt. 3, p. 2516.)

At that date, then, the question was not whether gains of this kind constituted income but to what extent they should be taxed when they had accrued during a period of years prior to the enactment of the tax law. The amendment above quoted was agreed to by the Senate. But, in the further progress of the bill through Congress, it was somewhat changed so that, as finally passed, the act of June 30, 1864 (13 Stat., c. 173, p. 223), contained the following:

> *And provided further*, That net profits realized by sales of real estate purchased within the year, for which income is estimated, shall be chargeable as income; and losses on sales of real estate purchased within the year, for which income is estimated, shall be deducted from the income of such year. (13 Stat., c. 173, p. 281.)

Thus Congress determined that it would tax income of this kind only when it resulted from a purchase and a sale made within the same year. This carries no implication of a want of power to tax such gains accruing previously but realized and received during a taxable year. It merely gives expression to the opinion entertained, at that time, that Congress should not go back of purchases made during the tax year.

The same provisions are carried into the act of March 3, 1865. (13 Stat., c. 78, p. 469.)

When Congress came to pass the act of March 2, 1867 (14 Stat., c. 169, p. 471), it was evidently of the opinion that the acts of 1864 and 1865 had been too restricted in this respect. The rule then adopted might be well enough in the case of personal property, which is the subject of more frequent purchases and sale, but real estate, as a rule, does not change hands so rapidly. At any rate, Congress thought that the profits realized from the sale of real estate should be taxed, even though the purchase and sale were not both made within the same year. It still thought, however, that the act should be restricted to such gains accruing during a comparatively short period. Hence, it inserted in the act of 1867 that, in estimating income for a given year, there should be included—

> profits realized within the year from sales of real estate purchased within the year or within two years previous to the year for which income was [is] estimated. (14 Stat., p. 478.)

Thus, all gains derived from the sale of real estate were taxed in the year in which received, provided the real estate had been purchased within the two preceding years. This, however, was an exception to the general rule applied in the statute that only gains derived from a transaction begun and ended in a given year should be treated as the income of that year. The point is that Congress fully understood that such gains constituted income. If they were income when they had accrued during a period

of two years, they were equally income if they had accrued during a period of 5 or 10 years.

The act of 1867 came before this court in *Gray* v. *Darlington*. (15 Wall. 63.) The question was whether a profit of $20,000, received by a sale in 1869 of bonds purchased in 1865, was taxable as income for the year 1869. The case involved no question as to whether this profit or gain was income, but only the question as to whether it was income which had been made taxable by the act of 1867. The syllabus of the case correctly limits the decision to a holding that an advance in the value of personal property during a series of years under the act of March 2, 1867, does not constitute income *of any one particular year of the series*, although the entire amount of the advance be at one time turned into money by the sale of property. Throughout the opinion it is made clear that this is the only point involved and that there is no question as to whether such gains are, in general, included in the term "income." Thus, at the very outset, in quoting the provisions of the statute, the court italicises the words "for the year ending the 31st of December next preceding," although these words are not italicised in the act. The provision above quoted, with respect to profits derived from the sale of real estate, is then set out. After stating the facts with respect to the purchase and sale of the bonds in question, the court said:

> The question presented is whether the advance in the value of the bonds, during this

> period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits, or income of the plaintiff for the year in which the bonds were sold. (Id., p. 65.)

It was not meant by this that the power of Congress to make such gains taxable for a given year was involved, but only that the question was whether the act of 1867 had made them so taxable. The court accordingly took up the statute and said:

> The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income. Its general language is "that there shall be levied, collected, and paid *annually* upon the gains, profits, and income of every person," derived from certain specified sources, a tax of 5 per cent, and that this tax shall be "assessed, collected, and paid upon the gains, profits, and income for the year ending the 31st of December next preceding the time for levying, collecting, and paying said tax." This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. (Id., p. 65.)

Thus the court construed the act of 1867 as expressing a purpose to tax profits realized from business transactions only when those transactions were begun and completed during the tax year. Mention was then made, however, of certain exceptions to this

general rule that the transaction must be begun and ended during the same year, the court saying (pp. 65–66):

> One of these exceptions is expressed in the statute, and relates to profits upon sales of real property, requiring, in the estimation of gains, the profits of such sales to be included where the property has been purchased not only within the preceding year but within the two previous years.

The conclusion was thus reached that, saving only the exceptions made by the statute, in the case of sales of property, Congress had intended to tax only the profits derived from both a purchase and sale during the same year. An exception, however, was made of sales of real estate. The bonds involved were not within any of the exceptions, and it was, of course, held that Congress intended that profits derived from their sale should be taxed only under the general rule of the statute. In the case, therefore, of sales made by investors, not as a part of a general trading business, the court assumed that, in the case of real estate, all profits accruing during a period of two years prior to the taxable year, as well as those accruing during the latter year, were taxable under the statute. That no doubt was entertained of the power of Congress to tax as income such profits when received, regardless of when the property sold had been purchased, is made clear by a further discussion of other features of the statute.

In the case of isolated sales by investors, the question simply is how much income has been

derived from a single transaction. It has always been recognized, however, as fair that where one is dealing, as a part of his trade or business, in property, buying and selling it, his net income shall be regarded as what he has derived from all such transactions. This was contemplated by the act of 1867, and the court said (p. 66):

> Another exception is implied from the provision of the statute which requires all gains, profits, and income derived from any source whatever, in addition to the sources enumerated, to be included in the estimation of the assessor. The estimation must, therefore, necessarily embrace gains and profits from trade and commerce, and these, for their successful prosecution, often require property to be held over a year. In the estimation of gains of any one year the trader and merchant will, in consequence, often be compelled to include the amount received upon goods sold over their cost, which were purchased in a previous year. Indeed, in the estimation of the gains and profits of a trading or commercial business for any one year, the result of many transactions have generally to be taken into account which originated previously. Except, however, in these and similar cases, and in cases of sales of real property, the statute only applies to such gains, profits, and income as are strictly acquisitions made during the year preceding that in which the assessment is levied and collected.

The court was also interpreting a particular statute and not dealing with the question of what is ordinarily included in the term "income" when it said:

> The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital. (Id., p. 66.)

The holding is not that, when such advance in value is realized by a sale, it is not income within the general meaning of that word, but only that it is not *the income specified by the statute.*

And in the concluding paragraph of the opinion it is made perfectly clear that, when the court speaks of income, it refers only to the income specified by the particular statute under consideration. It was said:

> The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in 10 years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes

place. We are satisfied that no such result was intended by the statute. (Id., p. 66.)

When the income tax acts of the sixties were passed the word "income" had the same meaning which it has now. When the first act levied a tax on annual gains, profits, and income, the executive department of the Government understood that profits derived from the sale of capital assets, no matter when purchased, were included. This brought the matter to the attention of Congress, where the construction adopted by the executive department was assumed to be correct. On this assumption, Congress considered not the power but the policy of taxing in a particular year such gains received in that year after having accrued over a period of years. It manifested its understanding that such gains constitute income by taxing them in some cases when the transaction out of which they arose had both commenced and ended in the same year, and in other cases when they had commenced and ended during a period of three years. In *Gray* v. *Darlington*, *supra*, the court, at least, assumed that the legislative conception of income and of the power to deal with it was correct. It did not question the power of Congress to treat as income for a particular year profits of this kind accruing during a period of years, but only held that, in the case of profits arising from the sale of bonds, Congress had not intended to levy the tax unless the transaction both began and ended during the same year. Certainly, at that time,

every department of the Government understood the term "income" to include gains derived from the profitable sale of capital assets.

When the act of August 27, 1894 (28 Stat., c. 349, p. 509), was passed Congress still understood that income included gains of this kind, and provided that in estimating gains, profits and income of any person there shall, among other things, be included—

> profits realized within the year from sales of real estate purchased within two years previous to the close of the year for which income is estimated. (28 Stat., p. 553.)

That statute, as is well known, was held in the *Pollock* case (158 U. S. 601) to be unconstitutional, not because gains derived from the sale of real estate were not income but because the tax upon rents and certain other things were, in effect, direct taxes upon property and could not, at that time, be levied without apportionment among the States. The act was subjected to the careful scrutiny and criticism of many eminent counsel, including the distinguished counsel for plaintiff in error in the present case. Every possible objection was made to the validity of the statute. As shown above, profits realized from the sale of real estate purchased within two previous years were classed with all other forms of income. And yet so well was this understood by the profession to be income that, in as powerful an assault as was ever made upon an act of Congress, the contention now advanced was apparently not thought of by counsel. If it did not occur to the

eminent counsel employed in that case—that such gains were not income—it may safely be assumed that, as generally understood at that time, the term "income" included gains derived from the profitable sale of capital assets.

The corporation excise tax act of August 5, 1909 (36 Stat., c. 6, pp. 11, 112), imposed "a special excise tax with respect to the carrying on or doing business" by corporations "equivalent to 1 per cent upon the entire net income * * * received by it from all sources during such year," and required corporations, under regulations to be provided by the Secretary of the Treasury, to report "for the year ending December 31, 1909, and for each calendar year thereafter," among other things, "the gross amount of the income of such corporation" received within the year from all sources. It was provided that the net income by which the tax was to be measured should be ascertained by making certain deductions from the gross income. No effort, however, was made to define "income." Apparently, Congress felt that no definition was necessary, since the term "income" already had a well-understood meaning. As we have seen, all branches of the Government had construed it to include the gains derived from the profitable sale of capital assets. Following this construction, the Secretary of the Treasury, in T. D. 1571, promulgated December 3, 1909, included the following:

> *Sale of capital assets.*—In ascertaining income derived from the sale of capital assets, if

> the assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item of gross income to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price.

And in T. D. 1606, promulgated March 29, 1910, section 71 was:

> Where increase or decrease during the year in the value of real estate acquired in previous years, sold or held for sale, can not be accurately determined, such increase or decrease may be prorated, as provided by regulations in cases of sale of capital assets.

And T. D. 1675, February 14, 1911, article 55 was:

> Lands bought previous to January 1, 1909, and sold during the year 1910, should have the profits arising from such sale prorated in accordance with the number of years the land was held by the corporation and the number of years the law was in effect, if no accounting of increased value of land was made in returns for previous years.

The same provision was in T. D. 1742, December 15, 1911.

The interpretation thus put by the Treasury Department upon the act of 1909, by including, in income, the gain derived from the sale of capital assets, has been repeatedly approved by this court. In *Stratton's Independence (Ltd.)* v. *Howbert* (231 U. S. 399), holding that income included the profits derived

from ores mined by a corporation from its own premises, the court, at page 415, defined income as follows:

> "Income" may be defined as the gain derived from capital, from labor, or from both combined.

In *Doyle* v. *Mitchell Bros. Co.* (247 U. S. 179), the precise contention now made was urged upon the court. In that case the company had acquired timber lands in 1903 at $20 an acre. Owing to increases in the market price of stumpage, the market value of these lands on March 1, 1913, was $40 per acre. The company was not a real estate trading corporation. It was engaged in manufacturing lumber from timber cut from its own lands. It was not questioned that the profits realized by the sale of this lumber constituted income; or that, in determining the amount of such profits, there must be deducted from the proceeds of sale not only the cost of manufacture but also the value of the stumpage. The company claimed the right to deduct this value as of December 31, 1908, at the rate of $40 per acre. The commissioner ruled, however, that it was entitled to the deduction only at the original cost of $20 per acre. The question, therefore, was whether the income contemplated by the act of 1909 included the profits resulting from the increase in price between 1903 and 1908, or whether this portion of the profit should be excluded and only that which could be said to have accrued after December 31, 1908, included. The court entertained no doubt that profits made by the sale of capital assets were income. A suggestion to

the contrary was decisively rejected, Mr. Justice Pitney saying, at page 183:

> The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income, although including an increment of value, we reject at once as inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received "from all sources."

The only difficulty arising in the case was thus stated:

> When we come to apply the act to gains acquired through an increase in the value of capital assets acquired before and converted into money after the taking effect of the act, questions of difficulty are encountered. (Id., p. 183.)

Rejecting also the contention on the part of the Government that the entire proceeds of a mere conversion of capital assets were to be treated as gross income, it was said, after referring to the definition of income above quoted from *Stratton's Independence* v. *Howbert:*

> Understanding the term in this natural and obvious sense, it can not be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many

> if not in most cases there results a gain that properly may be accounted as a part of the "gross income" received "from all sources"; and by applying to this the authorized deductions we arrive at "net income."

And then, laying down the rule for determining the income included in the proceeds of a sale, it was said:

> In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration. (Id., p. 185.)

The court then mentioned the fact that this was the view taken by the administrative officers of the Government from the beginning and, after reviewing the Treasury Decisions above quoted and others, said:

> In our opinion these regulations correctly interpret the act in its application to the facts of the present case. (Id., p. 187.)

Even more decisive is *Hays* v. *Gauley Mountain Coal Co.* (247 U. S. 189). The company in that case was a mining corporation. The business of trading in stocks was not included among its corporate powers, and it did not appear that, with a single exception, it ever bought or sold any. The single exception was the transaction involved in that case. That transaction was that the company had bought certain shares of stock of another company in 1902 for $800,000

and sold them in 1911 for $1,010,000, or an advance of $210,000. The question was whether the portion of this $210,000 which could be said to have accrued after January 1, 1909, should be included in the income by which the excise tax was to be measured. There was a contention that, at all events, interest on the amount originally invested should be deducted. This, however, was rejected by the court and the question squarely presented as to whether any portion of the $210,000 was income within the meaning of the act. The same contention now made was made in that case, and then, as now, rested chiefly upon *Gray* v. *Darlington, supra.* The court held, however, that that case was not controlling, saying, at page 191:

> We do not regard the decision as controlling, because the language of the act now under consideration is different in material particulars. As pointed out in *Doyle* v. *Mitchell Brothers Company, ante,* 179, it imposes annually a special excise tax with respect to the carrying on or doing business by the corporation "equivalent to 1 per cent upon the entire net income over and above $5,000 received by it from all sources during such year," to be ascertained by taking gross income and applying certain exceptions and deductions. "Gains, profits, and income *for* the year ending the 31st day of December next preceding" (act of 1867) conveys a different meaning from "the entire net income * * * *received by it* * * * *during* such year." (Act of 1909.) The former expression,

as this court held (15 Wall. 65), denoted "such gains or profits as may be realized from a business transaction begun and completed during the preceding year," with the exceptions already mentioned. The expression "income *received during* such year," employed in the act of 1909, looks to the time of realization rather than to the period of accruement, except as the taking effect of the act on a specified date (Jan. 1, 1909), excludes income that accrued before that date.

And speaking still of the act of 1909, as applied to profits derived from the sale of capital assets, it was said, at page 192:

> As we construe the latter act, it measured the tax by the income received within the year for which the assessment was levied, whether it accrued within that year or in some preceding year while the act was in effect; but it excluded all income that accrued prior to January 1, 1909, although afterwards received while the act was in effect.

And finally the court, at page 193, announced its conclusion thus:

> "It results that so much of the $210,000 of profits as may be deemed to have accrued subsequent to December 31, 1908, must be treated as a part of the "gross income" of respondent. For it is the simple case of a conversion of capital assets acquired before and turned into money after the taking effect of the act; and, as we have shown in *Doyle* v. *Mitchell Brothers Co., ante,* 179, since the

conversion of capital often results in gain, the general purpose of the act of 1909 to measure the tax by the increase arising from corporate activities together with the income from invested property leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the act must be regarded as "gross income;" and to this end it must be distinguished from that portion which represents a return of the capital value existing before. In order to do this, it is necessary to ascertain what was the value of the capital assets on December 31, 1908.

Whether the division of such income should be made by the prorating method provided by the Treasury regulations, above referred to, or by taking an inventory as of December 31, 1908, was not determined, for the reason that the prorating method had not been called in question.

There can be no doubt that the decisions referred to establish beyond controversy that when the act of 1909 measured the excise tax, then levied, by the net income of a corporation it included, in income, gains derived from the sale or conversion of capital assets, and provided that the amount of such income for a praticular year should be ascertained by first withdrawing from the proceeds of sale either the original cost or the value on the effective date of the act of the property subsequently sold, the remainder representing income received in the year of the sale. The fact that the act of 1909 was not an income-tax

law does not preclude these rulings from being decisive of the present case. Admittedly, the question here is what, in common speech, is meant by income. The word "income" can not be said to have been used in any unusual or extraordinary sense in the act of 1909. Although employed for a different purpose, it was used in exactly the same sense that it was used in the sixteenth amendment and the subsequent income-tax acts. In the act of 1909 it was used in the sense in which it had been used by all branches of the Government for many years. The meaning attached to it by this court, in interpreting the act of 1909, must be its meaning when used, without any qualifying words, in subsequent legislation.

The act of October 3, 1913 (38 Stat., c. 16, pp. 114, 166), was the first income tax law after the adoption of the sixteenth amendment. It levied a tax, to be paid annually, upon the entire net income "arising or accruing from all sources in the preceding calendar year." Its effective date was March 1, 1913. It provided that there should be included, in income, gains, profits, and income derived from, among other things, sales or dealings in property. It did not contain any provision for ascertaining such gains where the property was acquired before March 1, 1913, and subsequently sold. It will be seen that this act is like the act of 1909 in expressly fixing a date upon which it should become effective, but unlike that act in that, while the act of 1909 levied a tax to be measured by the income *received* during a

particular year, the act of 1913 levies a tax upon income *arising or accruing* during the year.

The first case under the act of 1913 was *Lynch* v. *Turrish* (247 U. S. 221), which is strongly urged by counsel upon the court as applying to the act of 1913 a rule different from that applied, by the cases above cited, to the act of 1909. An examination of the case, however, will show that there is nothing in the *Turrish* case which, in any way, recedes from the former decision that gains derived from the sale of capital assets are income. The question was whether Turrish should be required to report, as a part of his income for the year 1914, certain sums which he had received upon the distribution, by a corporation in which he was a stockholder, of all its assets. It appeared, however, that there had been no increase in the value of the assets so distributed between March 1, 1913, and the date of distribution in 1914. This was regarded as of controlling importance, for it was said (page 226):

> And in determining the application of the statute to Turrish we must keep in mind that on the admitted facts the distribution received by him from the Payette Company manifestly was a single and final dividend in liquidation of the entire assets and business of the company, a return to him of the value of his stock upon the surrender of his entire interest in the company, and at a price that represented its intrinsic value at and before March 1, 1913, when the act took effect.

In other words, the rule announced in the cases cited above, dealing with the act of 1909, that there is no gain or income until, out of what one receives for his holdings, there has been withdrawn the amount of his capital represented either by original cost or the value as of the effective date of the act. Turrish having received only his capital as it existed on March 1, 1913, it was held that he had received no income. Meeting apparently the contention that whether there had been a gain was not to be determined by the value of the assets on March 1, 1913, but by the amount of the original investment, the court held that *Gray* v. *Darlington* (15 Wall. 63) was controlling, because it could find no substantial difference between the language of the act of 1867 and that of 1913. This by no means determined that such gains as we are now considering are not income, but only that the terms of the act of 1913 exclude such income which accrued prior to the effective date of that act. This holding is not in any way in conflict with *Hays* v. *Gauley Mountain Coal Co.*, *supra*. In that case it was found that there was a distinguishing difference between the act of 1909 and the act of 1867, which called for the application of different rules of interpretation, and hence *Gray* v. *Darlington* was not controlling. In the *Turrish* case the act of 1913 was held to be like the act of 1867 and unlike that of 1909, and hence *Gray* v. *Darlington* was controlling. It will be seen later that the act of 1916, under which this case arises, abandoned

the language of the acts of 1867 and 1913 and adopted the language of the act of 1909. Hence, *Hays* v. *Gauley Mountain Coal Company* and not *Gray* v. *Darlington* is controlling.

That this court has utterly and finally rejected the contention that the profitable sale of capital assets does not result in income was made clear in *Eisner* v. *Macomber* (252 U. S. 189), arising under the act of 1916, when, at page 207, Mr. Justice Pitney, after repeating, from *Stratton's Independence* v. *Howbert*, the statement that " 'income' may be defined as the gain derived from capital, from labor, or from both combined," said that, after examining the dictionaries in common use, the court found little to add to this definition. What he added was:

> provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* case.

There could not be a plainer or clearer statement that income under the sixteenth amendment includes such gains in precisely the same way that it included them under the act of 1909, as interpreted by this court. It may be safely said, therefore, that Congress in passing income tax laws, or in levying taxes to be measured by income, has ever since 1864 assumed that income includes gains of the kind involved in this case; that under all the laws passed by Congress the administrative department of the Government has construed income to include such gains; that no

doubt on the part of this court of the correctness of this construction can fairly be said to be implied from anything it has said in interpreting any of the acts of Congress; that nearly every act which Congress has passed dealing with income has had to meet vigorous assaults at the hands of able and astute counsel, but that, until recently, no claim has been advanced that gains of this kind are not income. If any word can be said to have acquired a fixed meaning by congressional, executive, and judicial usage, the word "income" must be understood to include such gains.

III.

In the framing of State income tax laws it has been customary to treat income as including gains derived from the sale of capital assets.

Bearing in mind that we are seeking to ascertain the commonly accepted meaning of the word "income," it may be helpful to refer to income tax laws enacted by the various States. It is true that, in levying taxes, the States are not hampered by a constitutional provision, like the one in the Federal Constitution, requiring apportionment in the case of direct taxes. But when a State enacts a law with the express purpose of taxing income, its enumeration of what shall be included in income throws some light upon the generally accepted meaning of that word. It will be found that, in levying such taxes, the States very generally include, as income, gains derived from the sale of capital assets.

The Virginia income tax law (Acts of Virginia, 1903, c. 148, pp. 155, 160) provides that income shall include, among other things—

> the amount of sales of live stock and meat of all kinds, less the value assessed thereon the previous year by the commissioner of the revenue.

The Wisconsin income-tax act of July 15, 1911 (Laws of Wisconsin, 1911, c. 658, pp. 984, 985), provides that the term "income" shall include, among other things—

> all dividends or profits derived from stock or from the purchase and sale of any property or other valuables acquired within three years previous or from any business whatever.

The Massachusetts act taxes as income—

> the excess of the gains over the losses received by the taxpayer from the purchases or sales of intangible personal property, whether or not the said taxpayer is engaged in the business of dealing in such property. (*Tax Commissioner* v. *Putnam*, 227 Mass. 522, 524.)

The Hawaiian income-tax law (Session Laws of Hawaii, 1901, act No. 20, pp. 31–35) includes as income—

> profits realized within the year preceding from sales of real estate, including leaseholds purchased within two years.

The statutes cited indicate the very general view that income is commonly understood to include such gains as are involved in this case.

There may always be differences of opinion as to the extent to which they shall be taxed when they

have gradually accrued during a period of years; but the power to treat them as income for tax purposes, to whatever extent the legislative body deems proper, would not seem, at this late date, to be open to doubt.

IV.

The cases under the act of 1913 dealing with the distribution of corporate assets among stockholders are in no way in conflict with the Government's contention in this case.

Under the act of 1913 this court had occasion in three cases to determine under what conditions money received by a stockholder as dividends, or as a result of the distribution of corporate assets, was taxable income of the stockholder for the year in which received. These cases are referred to by counsel with the insistence that they are, in some way, in conflict with the contention that gains derived from the sale of capital assets constitute income. It is difficult to see how anything said in these cases can be given that construction. So far as they have any bearing on the question, they tend to sustain the Government's contention in that regard.

In *Lynch* v. *Hornby* (247 U. S. 339), the question was whether a dividend paid to a stockholder in 1914, but out of a surplus accumulated by the corporation prior to March 1, 1913, was income taxable in 1914. The surplus out of which the dividend was paid had been accumulated partly through the business operations of the corporation and partly through a very

great increase in the value of its timber lands. Unquestionably, prior to the declaration of the income the stockholder's interest in the increased valuation of the lands added value to his stock. As long as this value remained a part of the property of the corporation, each stockholder's share was an increment of value incident to and inhering in his stock.

On March 1, 1913, the value of the corporation's capital assets included this increase in the value of its lands. In exactly the same sense, the value of the stockholder's capital assets, represented by his stock, included his share in the increase in value of the lands. In each case it was an element in the value of capital assets. It was, however, an increment of value which had resulted from the investment of capital. It represented that out of which the investor must get his returns or income. The corporation itself would receive this income when it separated the increment of value from the original capital by a sale of the property. Likewise, the stockholder would receive his income when the corporation, after making a sale, paid to him, by way of dividends, his share of the increment of value which had accrued to his stock. As long as this increase remains a mere increment of value, it is, as said in *Eisner* v. *Macomber, supra,* "a gain *accruing to* capital," "a *growth or increment* of value *in* the investment," and is not income. But the moment it is "*severed from* the capital, however invested or employed," it may be said to come in, to be *derived,*

"that is, *received or drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal," and is income derived from property.

The question in *Lynch* v. *Hornby* was, when was the increment of value inhering in the stock severed from the capital of the stockholder—that is, when was it derived from his capital so as to become income to him. That when received as a dividend it was income was not questioned. The contention was that, although income, it had accrued prior to March 1, 1913, and hence, for the purposes of the act of 1913, was capital as of that date. For this reason, it was insisted that, as in the *Turrish* case, the dividends served merely to return to the stockholder his capital as it existed on March 1, 1913. The court, however, said:

> In our opinion it is distinguishable from the *Turrish case*, where the distribution in question was a single and final dividend received by Turrish from the Payette Company in liquidation of the entire assets and business of the company and a return to him of the value of his stock upon the surrender of his entire interest in the company, at a price that represented its intrinsic value at and before March 1, 1913, when the income tax act took effect. (Id., p. 341.)

It was then shown that in *Lynch* v. *Hornby* there was no surrender of the stock, and no winding up of the affairs of the company, but a mere distribution of surplus profits. It was pointed out that Hornby, as one of the stockholders, had only the ordinary

stockholder's interest in the surplus of the company and was entitled to receive anything from accumulated earnings only in the discretion of the directors. While profits derived through the sale by a corporation of capital assets constitute income *to the corporation* at the time of the sale, they do not become income *to the stockholders* until they are distributed. Speaking, therefore, of corporate profits that accumulated before March 1, 1913, but were not distributed until after that date, the court said (p. 343):

> As to these, however, just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a pre-existing surplus.

And on page 344:

> Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation. The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the

dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand.

Thus, what the court held was that the time at which the corporate earnings became income to the stockholders was the time at which they were distributed through dividends and thus received by the stockholders. So far as the case refers at all to the question now involved, it indicates that dividends declared for the purpose of distributing profits made by the profitable sale of capital assets stand upon exactly the same basis as dividends which distribute profits earned in the ordinary business operations of the corporation.

In *Southern Pacific Co.* v. *Lowe* (247 U. S. 330), certain dividends paid to a stockholder out of earnings accruing prior to March 1, 1913, were held not to be income. This was because, however, of the peculiar facts of the case. There was but a single stockholder, and that stockholder not only controlled the corporation but actually had the physical possession and control of all its properties. The court adhered to its ruling in *Lynch* v. *Hornby*, as applied to dividends received by ordinary stockholders, but said:

> While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control. And, besides, the funds

represented by the dividends were in the actual possession and control of the Southern Pacific as well before as after the declaration of the dividends. (Id., p. 337.)

In other words, under the peculiar facts of that case, the court was of opinion that the profits in question accrued not only to the corporation but to its sole stockholder before March 1, 1913, and hence that there was no income by the mere change in form of the relation of the two companies to these profits in 1914. For this reason it was held that the stockholder received no income which was taxable under the act of 1913. The only thing in the opinion which can be said to relate, in the slightest degree, to the question now involved is the statement following the holding just referred to (p. 335)—

> And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings and the increment due to an appreciation in value of the assets of the taxpayer.

Peabody v. *Eisner* (247 U. S. 347) involved a dividend paid by a corporation to its stockholder in the stock of another company. The only question involved was whether such a dividend came within the ruling in the *Southern Pacific Company* case or that in the *Hornby* case, and the court said (p. 349):

> In this case the plaintiff in error stands in the position of the ordinary stockholder, whose interest in the accumulated earnings and surplus of the company are not the same

before as after the declaration of a dividend; his right being merely to have the assets devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors in their discretion may declare; and without right or power on his part to control that discretion.

There was nothing said in that case which bears in the remotest degree upon the question now involved.

V.

The cases above referred to establish the proposition that gains derived from the sale of capital assets constitute income when received.

The cases which have thus far been reviewed recognize that whatever gains are realized as a result of the investment of money in property constitute income when received. They do not become income until separated from the original capital, and received in such a manner that they may be used by the recipient separate and apart from the capital assets. So long as the investor simply holds the property which he has purchased, any increase in value of that property is an increment of value *in* the investment. While the value of the property is increasing, there is a gain according to capital, but it is to the gain thus accruing, and to the increment of value thus in the investment, that the investor looks, in part, at least, for the returns on his investment. When he sells the property, he is entitled

to withdraw from the proceeds, as capital, the amount invested. The remainder is the returns, the profits, the income, derived from investing his money in property. It is separated from the capital and may be used without disturbing his original capital in the same way that interest paid on money loaned or rents received for the use of land may be used. It possesses all the elements of income and it would seem that the decided cases referred to indicate no room for doubt that it is income within the meaning of the act of 1916, which taxes all income in the year in which it is received.

VI.

Investments are ordinarily made in contemplation of two kinds of returns—one current income while the investment is held, and the other the profit to be realized, through appreciation in value, upon the final disposition of the investment.

That profits derived from the sale of capital assets are income is in accord with the common understanding and practices of men. The investor in property takes many things into consideration in determining whether the investment will be profitable. If his purpose is simply to secure to himself a fixed income, he will invest in property from which he may secure regular returns while he holds the property. On the other hand, he may not be so much interested in the current returns as in the final result of his investment. If so, he may conclude that the circumstances are such that a particular property, though yielding no current returns, is likely to increase very much in

value, and may invest in that property expecting to get the entire return from his investment upon finally making an advantageous sale. One man, therefore, will invest in improved real estate, from which he can derive a fixed rental. He is assured of an income. Ordinarily, however, he will select real estate so situated that it is likely to increase rather than decrease in value. By doing this, he hopes to keep his capital intact, but also indulges the further hope that, through an increase in value, he may at some time be able to sell at a price which will give him a profit over and above the current income which he has received. When he makes such a sale, the surplus over his original capital is a gain. He may then invest exactly the same amount of capital in other property and have, for whatever use he desires, the remainder of the proceeds of sale. The profit realized at the time of the sale has been derived from his capital in precisely the same sense that the rents received while he held the property were so derived.

Another man invests the same amount of money, but chooses to purchase unimproved property, which yields no return, or, at most, only enough to pay the current expenses of holding the property. He makes the investment, however, on his judgment that the property is going to increase very much in value within a few years. It is located in a rapidly growing city. He holds it for five years and sells it for ten times what it cost. Before he makes the sale, a gain has been accruing to his capital. There is an incre-

ment of value in his investment, but he has not taken this increment out and has received no income. When he sells, he takes out of the capital the gain which has been accruing and, after leaving his capital intact, has, separate and apart from it, a specific amount which he has derived from the investment of his capital.

In the two cases above supposed we have this situation: One man has received, from year to year, an income and has been required to pay an income tax on it. At the end of the period he has his capital intact. The other man has, during the same period, had the same amount of money invested, but has received no income and paid no income taxes. At the end of the period he disposes of his investment and takes out his gains in a lump sum. It can not, by any possibility, be said that this lump sum is any less income derived from property than the rents which the other man received from year to year.

It may be supposed that another man invests money in a flock of sheep, expecting to derive an income from the sale of the wool and the lambs. The sheep purchased are capital assets. While the wool is growing on their backs it is a gain accruing, which makes these capital assets more valuable. He may derive his profit in two ways: If he desires to continue to keep the flock of sheep, he shears them, leaving his capital intact, and sells the wool. This is his gain or income derived from the investment of money in sheep. No one would question that it is

taxable income. If he decides to dispose of his investment, however, he can sell the sheep for more with the wool on their backs than after they have been sheared. Suppose that the sheep are still worth just what they cost him, he can sell them the day before shearing for an increased amount to the extent of the value of the wool. If he makes such a sale, instead of shearing the sheep and then selling the wool, is there any reason for saying that, to the extent that the wool added to their value, he has not derived an income from his investment.

Another man decides to invest in bonds. If he buys the bonds at par, he knows exactly what he may expect to get at their maturity. There will be returned to him then exactly the amount he has invested. He can only expect, therefore, as an income from this investment, the interest which will be paid on the bonds. This interest, received from time to time, will be his income. But he frequently finds that business conditions and the demand for money are such that even bonds of undoubted solvency are selling at a discount. He finds that he can purchase bonds at 90 cents and makes an investment on that basis. At the time he invests, he knows exactly what he has to expect if he holds the bonds until maturity. He will receive, from time to time, income represented by the current payments of interest, and at maturity he will have returned to him his original capital plus $10 for every bond of the face value of $100. Can it be said that this $10 is

any less income than the annual interest paid before the maturity of the bonds? Or if, before maturity, he has an opportunity to sell at 95 cents and chooses to do this, is the additional $5 received for each bond any less income than the additional $10 would have been at maturity? Or if, instead of buying bonds, he had loaned his money and taken a note due 10 years from date, with interest payable at maturity, can it be said that the accumulated interest received according to contract at the maturity of the note is any less income than it would have been if divided into 10 equal parts and paid annually?

Still another man invests in corporate stocks. The value of such stocks at any particular time depends upon many considerations. He can not know what they will be worth at any particular time in the future, nor is he absolutely assured that he will, from time to time, receive a particular amount or any amount by way of dividends. These things will all depend upon the degree of prosperity which the corporation enjoys. If the corporation is prosperous and distributes a reasonable amount of its profits as dividends, he expects to receive a return in this way on his investment, and, as it is received, he must report it as taxable income. The company, however, may earn much more in the way of profits than its directors see fit to distribute in dividends. If so, these accumulated earnings add to the market or selling value of his stock. When he sells the stock, he gets the benefit of his share of these earnings in the

increased price. Is there any difference in principle between the gain thus received and the gains which he has received in the way of dividends?

It may be supposed that it is known that, on the 1st day of January of a particular year, the corporation will declare a dividend of 10 per cent. When this dividend is declared, the selling price of his stock will, for the time being, be to that extent, decreased. The day before the dividend is declared he can sell his stock for more than he can sell it for the day after the dividend is paid. Instead of waiting for the dividend, he sells his stock and gets, as a part of the purchase price, exactly the same 10 per cent which he would have gotten if he had held his stock and received the dividend in cash. In either event, he has derived from his investment 10 per cent of the par value of his stock. Is there any reason why this 10 per cent should be income in the one case and not income in the other?

What is attempted to be shown by the above illustrations is true of almost every transaction by which men invest money in property. If the gains made by purchasing, holding, and selling property are not income, then income derived from property will be confined within a very narrow scope, and the result will be that whether gains actually derived from the investment of money in property are taxable will depend, not upon the substance and effect of the transaction, but upon the form in which the investor chooses to clothe it.

VII.

The debates in Congress, when the act of 1913 was under consideration, do not show an understanding that such gains as are now in question were not understood to be income.

Counsel insist that the debates in Congress in 1913 show that Congress understood that such gains as those now in question are not income. In support of this contention, they quote from a statement made by Representative Hull when he was explaining to the House the provisions of the act of 1913. In answer to a question as to what would be the taxable income if a man this year sells property bought many years ago at a price not greater than its value last year, his reply was:

> My judgment would be that as to an occasional purchase of real estate not by a dealer or one making the buying and selling a business this bill would only apply to profits on sales where the land was purchased and sold during the same year. (50 Cong. Rec., pt. 1, p. 513.)

It will be noted that the question related to the provisions of the then pending bill. That bill, as above shown, followed the language of the act of 1867 and levied the tax on income arising or accruing during a particular year. Similar language in the act of 1867 having been held to confine the income from such a transaction intended to be taxed to income arising from a transaction both begun and ended in the same year, the natural inference was,

as stated by Mr. Hull, that the act of 1913 would be construed in the same way. The purpose to tax income arising from the sale of capital assets was, however, clearly expressed.

The only question was whether it should be confined to transactions occurring wholly within one year. Moreover, an examination of the full statement of Mr. Hull from which the above is taken, as it appears in the Congressional Record for April 26, 1913 (50 Cong. Rec., pt. 1, p. 513), shows that, throughout the statement, gains of this kind were regarded as income. The particular questions discussed were, what part of gains accruing during a period of years should be taxed in the year in which they were received, and also what deductions in the way of losses should be allowed. As shown above, under the act of 1909, the administrative department had prorated such gains according as the number of years during which they accrued was before and after the effective date of the act. It seems to have been assumed in the discussion that this method would be followed under the act of 1913. These questions, however, are not important as bearing upon the act of 1916. After the act of 1913 had been tried out, Congress, in framing the act of 1916, departed from the plan of levying the tax on income arising or accruing during a particular year and levied it upon the income received during the year. This changed entirely the rule which Mr. Hull supposed would apply to the act of 1913 by confining the tax to gains made in transactions begun and ended

during the year. It also departed from the prorating rule, which it was assumed would apply under the act of 1913, by making the value on March 1, 1913, the basis for determining the amount of gains. The statement quoted from Senator Clark as having been made during the debate in the Senate when the act of 1916 was under consideration, to the effect that a man would not be taxed at all if he purchased stocks in one year and two years thereafter sold them at an advance of $20,000, is the mere expression of an opinion by an individual Senator. As shown above, when the language of the act is examined, the opinion is clearly erroneous, probably overlooking the difference in the wording of the act of 1916 and that of 1913.

VIII.

The tax on gains derived from the sale of property is not confined to such gains arising from transactions conducted as a part of one's business or trade.

It is admitted that when, as a part of one's business or trade, he sells capital assets, and thereby derives a profit, the gain so derived becomes a part of the income of his business upon which he is taxed. It is insisted, however, that the act has no application to gains derived from an occasional or isolated sale of property which has been purchased as an investment. No language of the act is pointed out drawing any such distinction. The tax is levied broadly on gains derived from sales of property. The only thing in the act to which counsel can refer as giving any color to their claim is the provision allowing

deductions for losses. It is true that the general deduction for losses is made only for losses occurring in the conduct of a business. In addition, a deduction under certain circumstances is allowed for losses occurring not in the course of a business. This deduction is prescribed as follows in section 5 of the act:

> In transactions entered into for profit but not connected with his [the taxpayer's] business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom. (39 Stat., p. 759.)

The reason for these provisions is obvious. When one is engaged in a business requiring many transactions during a year he will doubtless make a profit on some and suffer a loss on others. The only fair way to ascertain what his income is, is to strike a balance between the gains and losses constituting his business, and hence business losses are permitted to be deducted. If, however, a man has but one transaction during the year, that transaction results in either a profit or a loss. If there is a profit, it is undoubtedly income to him; and if there are no other similar transactions, there are no losses to deduct. On the other hand, the Government does not guarantee to anyone an income or a profit on any transaction into which he enters. If, therefore, the single transaction results in a loss, he has simply failed to obtain an income which the Government can tax. If, however, he has an income from other

sources—as a salary or returns from fixed investments—there is no reason why he may not be required to pay a tax on the income actually received from these sources, without any deduction on account of his failure to make a profit in some other venture. In the provision above quoted, Congress has accorded a full measure of consideration to the occasional investor. It is assumed that one may, in the course of a year, though not engaged in a regular business, have several transactions out of which either gains or losses may result. It is, therefore, provided that, to the extent that he realizes profits from any of these transactions, he may offset losses that have resulted from other transactions. In other words, the investing of money for profit is put upon the same basis as conducting a regular business. A balance is struck between the gains and losses resulting from such transactions, and this balance is treated as the income from the combined transactions. A man who purchases any kind of property is ordinarily entering into a transaction from which he expects profit to result, although he may expect, in the meantime, to use the property for his own purposes.

In the case of deductions for business losses, these deductions are only allowed as against the gains incurred in that business. For instance, a merchant during a particular year, while making large profits in some lines, may suffer losses to a very much larger amount in other lines. The result will be that the losses of his business wipe out entirely the taxable income and, in fact, leave him a loser. He may,

however, be the recipient of a large income from other sources, entirely disconnected from his business as a merchant. As against this income, he can not deduct or set off the net losses incurred in his mercantile business. The same rule, as we have seen, applies to one who has both gains and losses in transactions not connected with his trade or business.

On the whole, the act would seem, in this regard, to have been framed upon principles of fairness and justice. But if its entire justice was not apparent, and its provisions deemed unwise, Congress alone could give relief.

IX.

Whether under the decisions of the English courts gains of this kind are treated as income can have no determining effect in deciding the question now at issue.

It is stated in the brief that the settled law in Great Britain is that the growth or increment of value in investments or the capital assets of a corporation when realized by sale (as distinguished from profits so realized where such sale is the taxpayer's trade or business) is principal or capital and not income, within the scope of the income tax laws of Great Britain and the British Dominions. A large number of cases are cited to support this statement. An examination of these cases, however, can throw but little light on the present question. In practically all, if not all, the cases cited, the question was whether the act of parliament levying a particu-

lar tax expressed the intention to tax such gains. The British Parliament is fettered by no such constitutional provisions as control the Congress of the United States in levying taxes. Its right to tax income does not depend upon a Constitution which distinguishes between the methods in which income taxes and direct taxes may be levied. The parliament, therefore, may, for purposes of a particular act, define income to include anything it chooses. Whether, therefore, it has in its various acts treated gains of this kind as income has been determined purely by considerations of policy. If, therefore, it has not seen fit to tax gains derived from the sale of capital assets, it does not follow by any means that such gains are not included in the term "income" as commonly understood. On the contrary, it merely results that the parliament has not deemed it wise to tax such gains, and therefore has excluded them from the definition of "income" which it adopted for the purposes of particular acts.

X.

The fact that under the laws of various States gains derived from the sale of capital assets are, as between a life tenant and a remainderman, treated as principal and not as income affords no reason for saying that such gains are not income which Congress may tax.

Great stress is laid by counsel upon the fact that in many of the States gains resulting from the sale of assets held in trust for the payment of income to a life tenant are treated, as between life tenant and

remainderman, as principal and not as income. On this is based an argument which the Government found unavailing in *Eisner* v. *Macomber, supra.* In that case the Government relied largely upon the fact that, under the laws of most of the States, stock dividends go to the life tenant and not to the remainderman. This court, however, held that, even in the States where this rule prevailed, stock dividends for the purpose of Federal taxation are not income. The rule prevailing in the various States is entitled to even less weight in this case. The terms upon which property is held in trust are prescribed by the instrument creating the trust. In determining the rights, therefore, of life tenant and remainderman, the courts are concerned alone with ascertaining the intent and meaning of that instrument. No technical rules of law are involved. The question is simply what did the creator of the trust intend. The purpose of creating a trust for the benefit of a life tenant is ordinarily to secure for that tenant as nearly a fixed and certain income as possible. If specific property is conveyed to the trustee, the author of the trust knows, within reasonable limits, what income will, in the ordinary course of events, result.

Conditions, however, may entirely change and it is usual to authorize the trustees, if they find it necessary, to change the income producing investment. This is generally authorized in such language as makes it clear that the intention is for the life tenant to receive only the ordinary income from

specific property or from such other property as may be substituted for it. In other words, almost invariably the trust instrument is so worded as to make clear the intention that the life tenant shall only receive the ordinary income from property and that any increase in the value of that property, whether realized or unrealized, shall inure to the benefit of the remainderman. In such cases, it does not follow that, by an advantageous sale of the trust property, the trustee has not received taxable income. He is required to pay the ordinary income from specific property to the life tenant. If he sees fit to sell this property, he is required to invest the proceeds in other income-producing property, and the ordinary income from the latter property must also be paid to the life tenant. But in making a profitable sale, he, like any other person, realizes for his beneficiary a profit, a gain, an income. True, under the terms of his trust, this income must be invested and the income from that investment also goes to the life tenant. If the law levying an income tax requires trustees, like individuals, to account for and pay a tax on income received, he will be required to pay a tax on this profit. The life tenant will probably be entitled to have this tax charged against the proceeds of the sale and not taken out of the ordinary income of the trust. The gains made by such a sale are taxable income. Whether, as between the life tenant and the remainderman, they go to the one or the other depends entirely upon the intent expressed

by the instrument creating the trust. The cases, therefore, to which counsel have referred can have no possible application to the question of whether gains of a particular kind are income within the common and ordinary acceptation of that term.

XI.

The construction of the act of 1916, under which the taxes in this case were collected, does not work any more hardship or injustice than is inevitable under any general tax law.

Counsel have cited certain examples of cases in which they say the Government's construction of the act of 1916 works hardship and inequality.

(*a*) It is said that there is great injustice in allowing deductions for losses in the case of a going business and not in other transactions. As we have seen, the law admirably guards against injustice in the matter of deductions for losses. The losses of a going business are deducted merely for the purpose of seeing what the net result or income of that business has been. And in the case of transactions for profit not connected with a regular business, exactly the same rule is applied. All these transactions are treated as a whole, and only the excess of profits over losses arising from them is taxed. It is difficult to see how any injustice results to anyone from this.

(*b*) It is said that in the case of property held for a long period by an investor, or as an investment of trust funds by a fiduciary, losses are not deductible

because such transactions are not entered into for profit. A sale is a transaction. If no profit results from it, no taxable income arises. If a profit does result, it requires no stretch of the imagination to say that the transaction was entered into, at least partly, for the purpose of securing the profit. If a sale is made for purposes of reinvestment, it is not an unfair inference that the controlling reason for the sale is that a more profitable investment can be obtained. If there have been a series of such sales during a given year, some resulting in losses and some in gains, it is not at all uncertain that the losses may not be deducted from the gains. If not, the most that could be said against the act is that, in this respect, Congress has failed to attain complete equality.

(*c*) It is said that great injustice is done by requiring the profit which has resulted from an increase in value through a period of years to be taxed as the income of the year in which it is received instead of prorating it through the years when it was accruing. This, however, was a matter which addressed itself to the legislative judgment. The prorating system would have entailed great administrative difficulties. A tax could not be levied each year during which the property was increasing in value, but during which it remained unsold. Such increases are subject to be controlled by changing conditions, and may finally be converted into losses.

Until received in some form, these increases are not income. To undertake to prorate them over a period

of years when they are received would require reassessments for those years. This alone would have been sufficient to justify Congress in rejecting the prorating plan. Moreover, the recipient of such gains gets the full enjoyment of the whole of them at the time they are actually received—that is, the time at which they became income. No part of them constituted income of a previous year, because they were then, at most, mere speculative or paper gains. The simplest and, after all, the most just way of treating the matter would be to say, as Congress has said, that these gains shall be treated as income of the year in which they are received. It is true that if the rate of taxation has been increased the taxpayer pays more taxes by delaying a sale of his principal. But, on the other hand, if the rate of taxation is decreased, he is the gainer by the delay. At any rate, if he goes free of taxes during the years when his property is increasing in value, it is difficult to see any great injustice in requiring him to pay taxes on his gains when they are actually received. But if it could be shown that, in some cases, the law bears harshly and unjustly upon some taxpayer, this would not justify the court in declaring the law invalid. As this court has frequently said, inequalities are unavoidable in the levying of any general tax. In view of this, the weakness of the cases of hardship pointed out would indicate that, with respect to the questions now at issue, Congress has succeeded to an unusual extent in attaining equality and justice.

XII.

The application of the law to the two transactions involved in this case.

So far as plaintiff in error seeks to recover the taxes paid on account of the United Verde Extension Mining Company stock transaction there is no difficulty. He purchased the shares in 1912 for $560 and sold them in 1916 for $13,931.22, making a clear gain on the transaction of $13,431.22. It appears, however, that the stock from the time he bought it increased in value, so that on March 1, 1913, it was worth $695. The Commissioner of Internal Revenue, correctly construing the law to entitle him to withdraw as capital from the proceeds of sale the value of his stock on March 1, 1913, deducted $695 instead of the original purchase price and collected the tax on the remainder, or $13,236.22. For the reasons above stated, plaintiff in error was plainly liable for the tax so collected.

With respect to the B. F. Goodrich stock, the situation is different. Plaintiff in error acquired this stock in 1912. It was acquired in a transaction in which he received this stock and a certain amount of cash in exchange for other stocks, which he had previously acquired by gift and bequest. He thus received 3,600 shares, which were worth $81 per share, or $291,600. He sold them in 1916 for $269,346.25, making a net loss on the entire transaction of $22,253.75. But it appears that, after he acquired these shares, their market value very rapidly declined until on March 1, 1913, the stock of the

company sold on the New York Stock Exchange at something in excess of $41 per share. On this basis the Commissioner of Internal Revenue determined that the total value on March 1, 1913, of plaintiff in error's 3,600 shares was $148,635.50. Holding that this was the capital value which was entitled to be withdrawn, as capital from the proceeds of sale, he deducted that amount from the selling price of $269,346.25, and collected taxes on the balance, or $120,710.75. It will be seen that, on the entire transaction, there was no gain, but, on the contrary, a loss of more than $22,000. The question is whether in such a case any taxable income was received. The theory of the commissioner was that the act of Congress capitalized the assets of a taxpayer at their value as it existed on March 1, 1913. In other words, he ruled that the value, as of that date, must always control, and that in all cases the difference between this value and a higher selling price is income received when the sale is made.

If this construction of the law is correct, a serious constitutional question arises. Whatever gains are made by selling property resulted from three acts—acquisition, holding, and selling. These three acts together resulted in a gain or a loss, according as the selling price is more or less than the acquisition price. It is said, therefore, that unless the entire transaction composed of the three acts mentioned results in a gain there is, in fact, no income. It is true that, between the date of acquisition and the date of sale, the market price of the property may have fluctuated,

so that there may have been times when a sale could have been made at a profit; but if the owner did not choose to sell and take his profit, no income, in fact, resulted from his mere ability to have done so. On the other hand, there may have been times when, if the owner had sold, his loss would have been greater than it was at a later date when he actually sold. But it is said that he was not required to sell when the price was at its lowest and take his loss, and that if he did not do so the question as to whether he finally made a profit or suffered a loss must be determined by comparing the purchasing and selling prices. In other words, the contention is that, under the commissioner's construction of the law, something is taxed which is not, in fact, income and which Congress was therefore without the power to tax except by apportionment.

After a careful study of the statute, the Solicitor General is forced to the conclusion that the commissioner has erroneously construed the statute. It clearly imposes the tax only on *gains* that are derived from the sale of property. It can not be said that there has been a gain resulting from a sale of property at less than it cost, no matter how long an interval may have intervened between the purchase and the sale. The error consists in giving too broad a scope to the rule laid down by the statute for determining the amount of taxable gain derived from sales made during a particular year. From the beginning, the income-tax acts had imposed a tax only upon gains derived from sale. As shown above, there had

been much discussion and difference of opinion as to whether all such gains should be taxed in the year in which received. It was contended that it would be unjust to tax all of such gains when they had resulted from a gradual increase in values during a long period of years. Following the act of 1867, it was, at first, thought that such gains should be taxed only when the transaction from which they resulted both began and ended in the tax year, or, at least, when the property had been purchased only a short time before the beginning of that year. There was also a doubt of the power of Congress to tax that portion of such gains which would be represented by the increase in value which had occurred prior to the adoption of the sixteenth amendment.

After much discussion, Congress determined that it would not confine the tax to gains made in transactions beginning and ending in the particular year, or within any fixed and arbitrary time before that year, but that it would simply exclude so much of the gains as could be said to have resulted from increases in value prior to March 1, 1913, practically the date of the adoption of the sixteenth amendment. There had also been a difference of opinion as to how, in such cases, the gains should be apportioned between taxed and nontaxed gains. Under the act of 1909 the Internal Revenue Department had adopted a prorating method, according to the number of years the property was held before and after the effective date of the act. Congress apparently regarded this method unsatisfactory, and

instead concluded that the better plan was to ascertain the amount of gains resulting from increase in value before March 1, 1913, by comparing the value on that date with the original cost price. When, therefore, it adopted the provision, which will be quoted below, it was dealing with the question as to how ascertained gains should be divided for the purpose of taxation under this act, or for ascertaining the income which Congress intended should be taxed in a particular year. For this purpose it used the following language:

> For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived. (39 Stat., c. 463, sec. 2 (c), p. 758.)

It seems difficult to escape the conclusion that this provision can have no application until it is first ascertained, by comparing the purchase and selling prices, that there has been an actual gain. When this has been ascertained, the value of the property on March 1, 1913, is to be taken as including that portion of the increase in value finally realized by a sale which occurred subsequent to that date. But when the selling price is less than the purchase price, there has been a loss instead of a gain, and hence there is nothing to which the value on March 1, 1913, can be applied.

Under a proper construction of the act, therefore, it must be conceded that the plaintiff in error was not liable for a tax on account of his transaction in the B. F. Goodrich Company stock.

Having made this concession, however, it is proper to make clear the Government's view with respect to a similar and related matter. As shown above, losses sustained in business or trade or in transactions entered into for profit are, under certain conditions, permitted to be deducted. Where these losses are allowed and have resulted from the sale of property purchased before March 1, 1913, Congress has made provision for ascertaining the amounts of such losses that may be deducted in much the same language used in providing for ascertaining the amount of income from such sources to be taxed in a particular year. The provision is as follows:

> *Provided,* That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained. (39 Stat., c. 463, p. 759.)

This provision, therefore, must be construed as it has been conceded the similar provision relating to income is to be construed—that is, it must first be ascertained by comparing the purchase and selling price that a loss on the entire transaction has been

sustained. When this fact is ascertained, we look to the value of the property on March 1, 1913, to determine how much of the loss resulted from a decrease in value prior to that time. Thus, if property was bought in 1910 for $2,000 and sold in 1916 for $1,000, there was a loss of $1,000. Since all gains, under similar circumstances, are not taxed as income, there was a similar purpose not to allow all such losses. Therefore, if it appeared that on March 1, 1913, the value of the property had decreased until it was worth only $1,500, $500 of the entire loss would be regarded as having resulted from decrease in value occurring before that date, and hence only the remaining $500 of the loss would be allowed as a deduction. On the other hand, if the value of this property had increased until it was worth $2,500 on March 1, 1913, and had then decreased in value until it was finally sold for $1,000, the actual loss would still be $1,000; but the fact that all of this decrease had occurred since March 1, 1913, would be established by the advanced value as of that date, and hence the entire $1,000 would be deductible, and the taxpayer would not be entitled to deduct the difference between the full market value on March 1, 1913, and the selling price. Again, if it appeared that the value had decreased until on March 1, 1913, the property was worth only $1,000 and was later sold for $1,000, there would still be a loss of $1,000; but no deduction would be allowed because the market value of $1,000 on March 1, 1913, would establish the fact that the entire loss had resulted from a decrease in value occurring before that date.

In the present case, if it could be said that, in any event, the plaintiff in error could deduct from the income derived from one transaction the losses suffered through the other, he would not be entitled to a deduction. The reason is that, while he suffered a loss on the entire transaction, the value of the stocks had so greatly decreased before March 1, 1913, that if he had sold then his loss would have been very much greater. He did not choose to take his loss at that time, but held the stock for a higher price, which he finally obtained. In other words, the entire decrease in value which resulted in his final loss occurred prior to March 1, 1913. There was thereafter no decrease in value which resulted in a loss, but, on the contrary, an increase in price which overcame, in part, the previous decrease, and there was no loss occurring under the terms of the act after March 1, 1913, which can be deducted.

From what has been said, it results:

1. The taxes paid on the gain derived from the sale of the mining company stock were properly collected.

2. There was no gain resulting from the sale of the B. F. Goodrich Company stock, and the taxes collected on account of that transaction were improperly collected.

3. The plaintiff in error is not entitled to any deduction from the income derived from the first transaction on account of losses sustained in the second.

CONCLUSION.

The demurrer, being general, it follows, from the concession made above, that the judgment of the court sustaining it and dismissing the suit must be reversed, but the reversal should be placed alone upon the ground that the declaration makes a case in which the plaintiff in error is entitled to recover one of the items of taxes sued for but not the other.

Respectfully submitted.

William L. Frierson,
Solicitor General.

February, 1921.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH, *Plaintiff in Error*,

vs.

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF.

Filed, as *amici curiae*, with permission of the Court, by

T. P. GORE,
HOKE SMITH.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX.

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T. P. GORE and HOKE SMITH, as *amici curiae.*

This case involves the construction of the Sixteenth Amendment to the Constitution. It also involves the construction and the constitutionality of the Income Tax Act of 1916.

The Sixteenth Amendment reads as follows:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration."

The Income Tax Act of 1916, reads in part as follows:

"Sec. 1. (a) That there shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income; and a like tax shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources within the United states by every individual, a non-resident alien, including interest on bonds, notes, or other interest bearing obligations of residents, corporate or otherwise."

The Constitution of the United States, from the time of its adoption, has contained the following:

"ARTICLE I, Section 2, clause 3. Direct taxes shall be apportioned among the several states which may be included within this Union, accordto their respective numbers * * *"

"ARTICLE I, Section 9, Clause 4. No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration, hereinbefore directed to be taken."

It requires no argument to show that the Tax Act of 1916 is in conflict with these provisions of the Constitution, unless it is saved by the Sixteenth Amendment.

Pollock vs. Farmers Loan and Trust Co. 157 U. S. 429 and 158 U. S., 601.

We became interested in this cause after the oral argument was commenced but before the Solicitor General had concedes ~~considered~~ in his argument that certain of the taxes protested in these two cases were invalid and therefore improperly levied and collected. This accounts, of course, for the absence herein of any further reference to those particular assessments.

THE SIXTEENTH AMENDMENT DOES NOT ENLARGE, AND WAS NOT INTENDED TO ENLARGE, THE TAXING POWER OF CONGRESS.

The power of Congress to lay and collect taxes is plenary with but one exception and with but two qualifications. One of the qualifications requires that direct taxes shall be levied in accordance with the rule of apportionment. The other qualification requires that indirect taxes (duties, imposts and excises) shall be levied in accordance with the rule of uniformity.

The Sixteenth Amendment does not enlarge and was not intended to enlarge the taxing power of Congress. It brings no new subject and no new object of taxaion within the power of Congress. It does not alter the extent of the taxing power, it merely changes the method of exercising that power with respect to incomes arising from real and personal property.

Before the adoption of the Sixteenth Amendment, Congress could tax real and personal property only by the rule of apportionment. Since the adoption of the Sixteenth Amendment, Congress can tax real and personal property only with the rule of apportionment, but it can tax incomes arising from real and personal property without reference to the rule of apportionment.

THE SIXTEENTH AMENDMENT DID NOT CHANGE THE CHARACTER OF THE THING "INCOME."

The Sixteenth Amendment did not change and did not undertake to change the essential nature or character of the Thing "income." It did not change and did not undertake to change the definition of the word "income." Whatever could be taxed only in accordance with the rule of apportionment before the ratification of the Sixteenth Amendment can still be taxed only in accordance with that rule,—excepting incomes arising from real and personal property.

So far as direct taxes and the rule of apportionment were concerned prior to the Sixteenth Amendment, all taxes fell within two categories: taxes on property and taxes on incomes arising from personal property as such, or taxes on incomes arising from real and personal property.

Direct taxes in the first category, direct taxes on real and personal property must still be laid in accordance with the rule of apportionment notwithstanding the Amendment. Direct taxes in the second category, direct taxes on incomes arising from real and personal property, by virtue of the Amendment, can be laid without reference to the rule of apportionment.

WHAT IS INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

This brings us to the controlling question in the case. What is income? What things does the word include as used in the Amendment, and what things does it exclude?

Does the word "income" as used in the Sixteenth Amendment include, and was it intended to include, accretion to capital, unearned increment or gains derived from the profitable sale of capital assets? The answer to this question decides the case.

When the Congress submitted,—when the States ratified the Sixteenth Amendment, did they intend to withdraw from the rule of apportionment all increase of value in real and personal property and subject such increase to direct taxation without reference to such rule? It should be borne in mind that the question is not whether unearned increment, whether incomes of capital values are taxable or non-taxable, but whether they are taxable in accordance with the rule of apportionment or without reference to such rule.

It some times serves to illuminate and to determine the correctness or incorrectness of a theory to consider its necessary implication, and its logical conclusions. The aggregate wealth of the United States on March 1, 1913, was approximately $200,000,000,000. The aggregate wealth of the United States today is approximately $300,000,000,000. Here is an increase of $100,000,000,000. A large part of this represents unearned increment; represents the increase of capital values in the hands of the self-same owners who held this property on March 1, 1913. According to the theory of the governmet, all this increase of capital values is liable to be taxed as income when realized

or when converted into cash. All the real and personal property in the United States was commuted or crystalized into capital as of March 1, 1913, by the Act of 1916. All increase in the value of such property since that date is constituted and denominated income; is classified, characterized and defined as income of those who owned it on that date. All unearned increment, all increase in the value of personal and real property acquired since March 1, 1913 *or acquired subsequent to the present hour*, will according to the theory of the government, automatically come within the category of income the moment it is sold, and will be subject to a direct tax without apportionment.

Again, when it is remembered that the normal tax is 8 per cent, and when the income exceeds $100,000 a fifty-two per cent surtax is added, and these taxes increase rapidly until they reach seventy-three per cent, it will be seen that the construction urged as to the Sixteenth Amendment practically wipes out the security and protection for which the States stipulated in respect to direct taxes at the time of the adoption of the Constitution.

THE GOVERNMENT UNDERTAKES TO MEASURE THE INCREASE IN VALUE BY MONEY, WHICH HAS, ITSELF, DEPRECIATED IN VALUE.

The Government undertakes to fix the increase in the value of investments by the money for which it was sold during the year of the assessment, less the market price in 1913, and this is to be done without reference to whether money has itself depreciated in value, having lost much of its purchasing power. To illustrate: Between March 1, 1913, and June 1, 1920,

the price at which an investment could have been sold might have increased fifty per cent and yet the money so received might have decreased in purchasing power to the same extent. An investor whose property in 1913 would have brought $100,000 might have sold it in January, 1920, for $150,000, and, under this proposed assessment, he would have been compelled to pay a large income tax. With the amount left him he could not have purchased those commodities which could have been purchased in 1913 for $100,000, purchasing power of his capital not having increased.

A SALE CAN NOT CHANGE INCREASED VALUE OF INVESTMENTS FROM CAPITAL TO INCOME.

The following question should be considered and decided at this point: When does unearned increment, when does such increase of capital values become "income?" Is it income the moment it accrues in the hands of the owner; or does it assume the character of income only the moment it is realized or sold by the owner? If it is income the moment it accrues in the hands of the owner, then it is subject to a direct tax as such within his hands to the same extent as when realized by sale. If it is not income so long as it remains in his hands unsold, then it must be capital. But would the mere sale of capital change its essential character from capital to income? We insist that this unearned increment, this increase of value, is the same in its essential character before and after sale. Sale could not change the essence of the thing. This unearned increment, this increase of value must of necessity fall in one or the other of these two categories: It must be capital, or it must be income.

If the contention of the Government be well founded that this unearned increment, that this increase of capital value is income the moment after it is sold, can the conclusion be resisted that it was likewise income the moment before it was sold? If it was income, and not capital prior to the sale, then it would be subject to a direct tax under the Sixteenth Amendment without apportionment. There is but one escape from this conclusion, and that is, the mere act of sale converts a thing, which in its nature is capital, into a different thing which in its nature is income.

ILLUSTRATIONS GIVING THEORY, IN RELIEF.

A double illustration may here serve to present our theory in relief. (1) A, whose business is buying and selling property, purchased on March 1, 1913, among other pieces of property, a manufacturing establishment at a price of $100,000. He sold it two days later at a profit of $5,000. This would undoubtedly be income, determined by the character and circumstances of his business. (2) B, who is a manufacturer, purchased a similar manufacturing establishment on March 1, 1913, at a price of $100,000. He operated the plant until the summer of 1918. He made no improvements, but merely maintained the property intact. He sold it in the summer of 1918 for $200,000. Was this increase of $100,000 income, or was it an advance in the value of his capital? However that question may be decided, it certainly was, in one sense, his capital. It was his entire capital. It was exactly the same plant which he had purchased, it was in all parts essential to the conduct of his business, it had exactly the same capacity as on the day of its purchase and was

suited to exactly the same needs and requirements and no more. Let us assume, however, that the Government's theory was correct, and that this $100,000 was income and not capital, and that he was required to pay—let us say—an income tax of $40,000 upon the realized profit. Now let us assume that three months later, B decides to re-enter the manufacturing business. He obtains a price on the plant which he had sold three months before. The price is the same that he received, $200,000. But he has only $160,000 of the proceeds with which to rebuy this identical plant. This plant is undoubtedly capital in the hands of the party who purchased from B. He required the entire plant and the equipment for the conduct of his business. If B should re-purchase it, it would be capital in his hands. It would simply be the replacement of his capital. Was the $100,000 advance in the value of the plant, capital, or income? If it was capital in the hands of B., prior to the sale; and if the same property is capital when received by the purchaser, how can it be said that $100,000 of the amount received by B. was capital and $100,000 income and subject to tax?

A man has owned a farm for a number of years. The farm is his capital. Farm land has increased greatly in value. He wishes to sell his farm and buy another farm of equal value. If the theory of the Government prevails his capital will be so reduced the purchase can not be made.

A man owning a store may conclude to change his place of business. The property in the place of his business has increased substantially in value since his purchase. His store property is largely his capital; he sells it, and if the income tax is taken out of his

increase he can not buy a place of similar value in his community, because the income tax taken from the increased value of his capital would leave him not sufficient with which to buy the other property. It would simply destroy the privilege of changing capital from one investment to another.

CONGRESS AND THE STATES DID NOT INTEND TO SUBJECT INCREASE IN VALUE OF CAPITAL TO A TAX AS INCOME.

Did Congress intend, and did the several states intend, to render such an advance in the value of capital subject to a direct tax as income without apportionment? To answer this question, the Court should assume the point of view of the Congress when the Sixteenth Amendment was submitted, and to assume the point of view of the several states at the time this Amendment was ratified. The Court should consider the historic background, the judicial precedents, and all other circumstances which acted upon and influenced the Congress and to which the Congress reacted in the consideration of the proposed Amendment.

In *Eisner vs. Macomber*, 252 U. S., 189, Mr. Justice Pitney points out the occasion for the adoption of the Sixteenth Amendment and the necessity which requires that it shall not be extended by loose construction.

In that decision he says:

> "The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution, and the effect attributed to them before the amendment was adopted. In in-

come tax cases under the Act of August 27, 1894, it was held that taxes upon rents and profits of real estate, and upon returns from investments of personal property, were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership, and that Congress could not impose such taxes without apportioning them among the states according to population as required by Article I, Section 2, cl. 3, and Section 9, cl. 4, of the original Constitution.

"Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted in words lucidly expressing the object to be accomplished. * * * As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income.

(Citing authorities.)

"A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population of direct taxes upon property real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts."

The court is therefore, called upon to construe the Sixteenth Amendment, and to determine the extent to which the authority therein given Congress "to lay and collect taxes on income from whatever source derived" removes the original constitutional requirement that direct taxes shall be apportioned among the states according to population.

What was the general and ordinarily accepted meaning of the word "income" in 1909 when Congress submitted the Sixteenth Amendment to the states? And what was the generally and ordinarily accepted meaning of the term at that date and when in 1913 the amendment was ratified by the Legislatures of the States?

> "In the construction of the language of the Constitution * * * we are to place ourselves as nearly as possible in the condition of the men who framed that instrument." (*Ex parte Bain,* 121 U. S., 12) and "that which it meant when adopted, it means now." (*South Carolina vs. U. S.,* 199 U. S., 448.)

THE SIXTEENTH AMENDMENT WAS FRAMED AND ADOPTED, RELYING ON GRAY VS. DARLINGTON.

No responsibility placed upon Congress is greater than that of preparing an amendment to the Constitution, and the language used is, of course, subjected to the most thorough scrutiny.

A constitutional amendment is each House is referred to the Judiciary Committee, and we may accept it as true that the language of a proposed constitutional amendment receives the most careful consideration.

When considering the terms of a proposed amendment, the first luminary to which Congress turns for light and guidance is the Supreme Court of the United States. Congress through the Sixteenth Amendment was seeking to meet the decision of the Supreme Court in the Pollock case, and to subject not capital in any form, but incomes to taxation without appor-

tionment and the Congress was selecting language to carry out this purpose.

Turning to the decisions of the Supreme Court, Congress had before them the leading case on the subject, the celebrated case of *Gray vs. Darlington*, 15 Wallace, 63. In that case it had been expressly declared that increases in the value of investments, extending over a period of years, constituted capital, and did not constitute income. This decision was rendered by the Supreme Court in 1872. It had never been overruled. Its soundness had never been questioned. It enabled Congress to use, in the Sixteenth Amendment, the words, "income from whatever source derived," with the definite knowledge that these words would not take away from the increased value of investments, sold or unsold, its status as capital, and would not subject it to taxation without apportionment.

In *Gray vs. Darlington*, the Court was ruling upon the income tax act of 1867. This act provided "that there shall be levied, collected and paid, annually upon the gains, profits or income of every person residing in the United States whether derived from any kind of property, rents, interest, dividends or salaries or from any profession, trade, employment, or vocation, carried on in the United States or elsewhere, or from any other source whatever," a tax of five per cent. The act further provided (Sec. 117) that the tax should apply to "all other gains, profits, or income *derived from any source whatever.*" It further provided that the tax should be "assessed, collected and paid, upon the gains, profits or income for the year ending on the thirty-first day of December next pre-

ceding the time for levying, collecting and paying said tax."

In *Gray vs. Darlington,* the plaintiff was the owner in 1865, of certain treasury notes which he exchanged for United States bonds, and in 1869, the year the tax was assessed, he sold these bonds at an advance of $20,000.00. He realized the increased value of his investment by turning it into money the year the tax was assessed. It was the increased value of his investment turned into cash, and "derived" by him the year of the assessment, which the Government sought to tax as income.

The Court held this increased value of investment, turned into cash by the sale of the investment during the particular year, was not gains, profits or income derived from the property during that year, and decided that the sale of the investment at an advanced price did not change capital to income.

In *Gray vs. Darlington,* Mr. Justice Fuller, delivering the opinion of the Court declared on page 66:

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. *It constitutes and can be treated merely as increase of capital.*"

We repeat: the bonds in this case were sold; the taxpayer changed his investment from bonds into money; there was an increase of $20,000 which he received in excess of what he paid. The act of 1867 taxes "all other gains, profits, or income derived from any source whatever." The Supreme Court ruled that this in-

crease in the value of the investment, though the investment was sold and money received from it during the year of the assessment "constitutes and can be treated merely as increase of capital."

THE SIXTEENTH AMENDMENT DOES NOT ENLARGE THE MEANING OF THE WORDS AS USED IN THE ACT OF 1867.

When the Sixteenth Amendment was passed by Congress there was no enlargement of the meaning of the words used, from those used in the act of 1867. In the act, the language used was: "income derived from any source whatever;" in the amendment, the language was "income from whatever source derived." *The Congress knew that this language did not extend to the increased value of investments, because the Supreme Court had so decided.* They safely used the language without fear that they were removing the increased value of investments from the constitutional safeguard of being free from direct tax unless apportioned.

In *Lynch vs. Turrish,* 247 U. S., 221, the Court followed *Gray v. Darlington,* and quoting from that case among other things said (p. 230):

"This case has not been since questioned or modified.

"The Government feels the impediment of the case and attempts to confine its ruling to the exact letter of the Act of March 2, 1867, and thereby distinguish that Act from the Act of 1913, and give to the latter something of retrospective effect. Opposed to this there is a presumption, resistless except against an intention imperatively clear. The Government, however, makes its view depend

> upon disputable differences between certain words of the two acts. It urges that the Act of 1913 makes the income taxed one "arising or accruing" in the preceding calendar year, while the Act of 1867 makes the income one "derived." Granting that there is a shade of difference between the words, it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the disputes of purists. Besides, the contention of the Government does not reach the principle of *Gray vs. Darlington,* which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore as "arising or accruing," to meet the challenge of the words, in the last one of the years, as the Government contends, and taxable as income for that year or when turned into cash. *Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."* (Italics ours.)

We must believe that the language of the Sixteenth Amendment was used by Congress with full knowledge of the principle decided in *Gray* vs. *Darlington,* and with the intent not to tax as income increased value of investment sold or unsold.

ENGLISH INCOME TAX ACTS AND DECISIONS.

Prior to the adoption of the Sixteenth Amendment, the English courts had definitely decided that the profits derived from the sale of capital investments at an advance over cost was still capital and did not produce income. The English Income Tax Act of 1853 levied an income tax: "For and in respect of the annual profits or gains arising or accruing to any per-

son residing in the United Kingdom from any kind of property whatever whether situate in the United Kingdom or elsewhere and for and in respect of the annual profits arising or accruing to any person residing in the United Kingdom from any profession, trade, employment or vocation, whether the same shall be respectively carried on in the United Kingdom or elsewhere to be charged for every 20 shillings of the annual amount on such profits or gains," 7 pence, etc.

16th and 17th Victoria, Great Britain Public General Statutes 1852-53, sec. 34, page 262.

During a long period of years the courts of England have held that the increase in value of investments, even though realized by sale, was still capital assets and not taxable as income under their income tax laws, and when, in England, there was no constitutional limitation.

In the case of *California Copper Syndicate, Ltd. vs. Harris*, (1904 Echequer Scotland) 5 Tax Cases 159, Lord Justice Clerk stated the rule as follows:

"It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of invest-

ment, but an act done in what is truly the carrying on, or carrying out, of a business."

So far as the question involved is concerned the Act of 1842 does not differ from the Act of 1852.

In *Taxation Commissioners vs. Mooney* (1907 Privy Council), A. C., 342, 360, Lord Macnaughten, delivering the opinion, stated:

"A change in the form of property by a person who does not traffic in that kind of property, can not be regarded as producing income taxable under the Income Tax Acts."

In the case of *Hudson's Bay Co. Ltd. vs. Stevens* (1909 Court of Appeals), 5 Tax cases, 424, 436, 437, 440, Lord Justice Farwell said:

"It is well settled that income, not capital, is taxable under the Income Tax Acts. * * * It is clear, therefore, that a man who sells his land, or pictures, or jewels, is not chargeable with income tax on the purchase-money or on the difference between the amount that he gave and the amount that he received for them. But if instead of dealing with his property as owner he embarks on a trade, then he becomes liable to pay, not on the excess of sale prices over purchase prices, but on the annual profits or gains arising from such trade, in ascertaining which those prices will no doubt come into consideration."

In the case of the *Tebrau (Johore) Rubber Syndicate Ltd. vs. Farmer* (1910 Exchequer, Scotland), 5 Tax Cases 658, 664-5, Lord Salvesen stated:

"I am unable to distinguish the position of the Appellants from that of a person who acquires

a property by way of investment and who realizes it afterwards at a profit. It is well settled that in such a case the profit is not part of the person's annual income liable to be assessed for income tax, but results from an appreciation of his capital."

From these decisions it is clear that the Courts of Great Britain in considering their income tax laws drew the distinction between a trader and an investor, and held that, if the sale was by a trader in the course of his business, the profit would be income and taxable; but, if the sale was of a capital investment made at a price in advance of the cost, the proceeds were capital and not income. In the *Californian Copper case* (*supra*), 5 Tax Cases, 166, Lord Justice Clerk said:

> "The question to be determined being—Is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit making?"

The same rule of construction has been adopted in Canada, Australia and South Africa.

Their courts have followed the rule that the proceeds of property sold are prima facie capital, and not income, and that the term income does not include the difference of the cost of the property, and the price at which it is afterwards sold, unless the buying and selling of such property is the ordinary business of the person alleged to be a tax payer.

Pontifex's Canadian Income Tax, 23;
Bedell's Australasian Judicial Dict., 76;
Barnes Income Tax Practice in South Africa, 137-140.

See, also, to the same effect as the British decisions quoted, the following:

Assets Co. Ltd. v. Forbes, 3 Tax Cases, 542, 548

Scoble v. Secretary of State for India, A. C. 299, affirming 1 K. B., 494.

Commissioners of Taxes v. Melbourne Trust Ltd., A. C. 1001, 1010;

Webb v. Australian Deposit Bk., Ltd., 11 Commonwealth Law Rep., 223, 227;

McLachlan vs. Commissioner of Taxes, South Australian Law Reports, 138;

Bohemian Club vs. Acting Commissioner, 24 Commonwealth Law Reports, 334;

Shiels vs. Commissioner of Taxes, South Australian Law Reports, 175;

Commissioner of Taxes vs. Booyesen's Estate Ltd., South African Law Reports, 1918, App Div. 576;

Northern Assurance Co. vs. Russell, 2 Tax Cases 577;

Scottish Investment Co. vs. Forbes, 3 T. C., 231.

THE DECISIONS BY THE STATE COURTS SHOW THAT INCREASE IN VALUE OF INVESTMENTS IS NOT CHANGED FROM CAPITAL TO INCOME BY SALE.

The distinction between income and capital which we have been urging has been recognized in nearly every state in the Union. We do not insist that the Congress would be expected to be familiar with all these cases, but we do urge that their general effect was known, and especially was it understood in the states when the Sixteenth Amendment was ratified. And when Congress and the states used the words in the Sixteenth Amendment "income from whatever source derived" it is to be presumed that they possessed

knowledge of the meaning attributed to these words by the decisions of the various courts.

Over and over again in the states has it been held that the gains realized from the sale of capital assets held in trust for the benefit of a tenant for life were principal, and that the life tenant, entitled to the income of the fund, could not receive any part of the advance in value realized by the sale of invested capital. This gain having been uniformly treated as an increment to principal, a part of the capital and not income.

These decisions established a definite meaning for the word "income."

In the Cyclopedia of Law and Procedure (39 Cyc., 444), the following rule is laid down:

> "As instruments creating trusts frequently provide for the payment of income to one set of beneficiaries, and the corpus to another set, it often becomes necessary to decide what is included within the term 'capital,' and what within 'income.' In general, the capital or corpus of the trust estate includes not only the property which originally comes into the trustee's hands, but its increase in value and whatever subsequently takes its place and represents it; hence, it includes the money, including the profits, derived from a sale of stock, bonds, or other property of the trust estate."

Many conveyances in trust have been made from which the life tenant was to receive the income from the investment, and the remainderman the capital, on the death of the life tenant. Under these circumstances the question has arisen as to what is income, and the courts have held that the sale of the property

by the trustee for an advance price is not income, and does not go to the life tenant in the absence of some specific provisions in the deed of trust giving it to him.

In a case of this kind (*ex parte Humbird* 114 Md., 627), the court says:

> "The fact that as here the property may have been unproductive of income does not affect the ownership of its augmented value. This consideration might influence its purchase or retention as an investment, but would not change from corpus to income any part of the fund realized from its sale."

In *Parker vs. Johnson*, 37 N. J. Eq., 366, the original investment was increased and sold for an advanced price. Was the life tenant entitled to this advance as income, or did it become part of the capital? It was held that the increase derived from the sale must be reinvested as capital, and not distributed as income. The court stated:

> "The profit is not income. It was made by the trustee in the process of converting the investment, and like a premium realized on the sale of Government Bonds in which the funds might be invested, it belongs to the fund."

In the sale of bonds it has been universally recognized that the increased value received belongs to the capital of the trust estate, going to the remainderman is not distributed to the life tenant as income.

Re Graham's Estate, 198 (Pa.) St. 216;
Matter of Gerry, 103, N. Y., 445;
Devenney v. Devenney, 74 O. St. 96 (77 N. E., 688);
Whittingham v. Scofield's Trustee, 67 S. W., 846 (Ky.).

In *Smith v. Hooper*, 95 Md., 16, the Supreme Court of Maryland said:

> "The word 'income' is not synonymous with increase. The value of stock may be increased by good management, prospects of business and the like, but such increase is not income. The conversion of some of the shares into money resulted merely in substituting the cash received for the shares thus sold, and if the unsold shares, represented nothing but capital though capital of largely increased value, the money obtained for the shares when sold can represent nothing but capital either."

(See also to the same effect as cases cited 103 N. Y., 445, *Matter of Gerry*.

Graham's Estate, 198 Pa. St., 216;
Lauman v. Foster, 157 Ia., 275;
Slocum v. Ames, 19 R. I., 409;
Carpenter v. Perkins, 83 Conn., 11;
Guthrie Trustees v. Akers, 157 Ky., 649;
Devenney v. Devenney, 74 O. St., 96;
Jordan v. Trust Estate of Jordan, 111 (Me.) 124;
Bankhead v. Mulholland, 85 S. O. (Miss.) 111.

CONGRESS COULD NOT HAVE INTENDED THE SIXTEENTH AMENDMENT TO TAX AS INCOME INCREASED VALUE OF INVESTMENTS, AND WITH SUCH A PROVISION, THE AMENDMENT WOULD PROBABLY NOT HAVE BEEN RATIFIED.

The history of our own tax legislation and the terms therein used may well have been within the congressional mind when the income amendment was passed. And if so, it simply fortifies the view that

the language used was intended to restrict, not broaden, the accepted definition of "income." The tax act of 1861 limited the levy to "income." The tax act of 1862 and 1864 broadened the phrase to "gains, profits or income." The tax act of 1865 changed this phrase to "gains, profits and income." The addition of these words "gains" and "profits" must have been thought to broaden the scope and effect of the statute. When the constitutional amendment was adopted by Congress, the constitutional amendment went back to the simple word "income" with the evident intention of limiting rather than broadening its effect.

We have shown that at the time Congress passed and submitted to the States the Sixteenth Amendment the Supreme Court of the United States, the courts of many of the States, the courts of Great Britain, and the courts of her Colonies and the Dominions, had all decided that increased value of investment was capital, and that sale did not change the increased value from capital to income. It is impossible to conceive that Congress was not reasonably familiar with these decisions. It is impossible to conceive that when the words "Income from whatever source derived" were used, Congress did not know that these words had been uniformly held not to cover increased value of investment sold or unsold.

It is impossible to conceive that Congress intended by the Sixteenth Amendment to take increased value of income sold or unsold, from the constitutional requirement that, when taxed, it should be by apportionment.

If they had intended this amendment to take increased value of investments or capital out from un-

der the constitutional rule of apportionment, how easily they could have added to the words "income from whatever source derived," the words, "which shall include increase in value of capital investments." But if this language had been used, and Congress had been brought face to face with the fact that it was proposed to tax for all time to come, increased value of investments or capital, without apportionment, does anyone doubt that Congress would have rejected the amendment? Going one step further: if the amendment had been so written, does anyone believe three-fourths of the States would have ratified it?

The states had always been jealous of conceding the power of taxation to the federal government. Under the articles of confederation, the federal government had no powers of taxation. The Congress submitted to the States two different amendments empowering the federal Congress to levy taxes. Both amendments failed. The clause in the Constitution in regard to the apportionment of direct taxes, etc., was one of the three compromises essential to the adoption of the Constitution itself. The proper rule of construction in this case would seem to be that the Sixteenth Amendment should be strictly construed as respects the federal government and the power conferred, and should be liberally construed as respects the state governments and the power retained. If the Brief of the Solicitor General in this case had been presented to the Congress and the several state legislatures as an argument in behalf of the Sixteenth Amendment might it not have reversed all the history of the action?

THE EXCISE TAX ACT OF 1909 PLACES A TAX UPON CORPORATE ACTIVITIES.

The Solicitor General seeks to escape the force of the construction given to income "from whatever source derived" in the Sixteenth Amendment by decisions of the Court applicable alone to the excise tax act.

No question arose in these cases as to the power of Congress to tax incomes as distinguished from capital. The excise tax was levied upon doing business in a corporate capacity. The advantage of corporate existence influenced the legislation and the gains from corporate activities arising from these advantages were to be taxed. In *Anderson vs. 42 Broadway Company*, 239 U. S., 69-72, the Court said:

> "The act of 1909 was not in any proper sense an income tax law nor intended as such, but was an excise upon the conduct of business in a corporate capacity; the tax being measured by reference to the income, in a manner prescribed by the act itself."

In *Doyle vs. Mitchell Bros.*, 247 U. S. 179, the Court said the tax was imposed:

> "Not upon the franchises of the corporation irrespective of their use in business nor upon the property of the corporation, but in the doing of corporate or insurance business and with respect to the carrying on thereof."

In the same case the Court further said:

> "An examination of these and other provisions of the act makes it plain that the legislative pur-

pose was not to tax property as such or the mere conversion of property, but to tax the conduct of the business of corporations organized for profit by a measure based upon the gainful returns from their business operations and property from the time the act took effect. * * * "Selling for profit is too familiar *a business transaction* to permit us to suppose that it was intended to be omitted from consideration in an act for *taxing the doing of business in corporate form* upon the basis of the income received "from all sources.""

In the case of ***Hayes vs. Gauley Mountain Coal Company***, 247 U. S. 189, the Court said:

> "Since a conversion of capital often results in gain, the general purpose of the Act of 1909 to measure the tax by the increase arising from corporate activities, together with the income from invested property leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the act must be regarded as gross income."

These decisions were all placed upon the ground that the tax was an excise tax upon corporate activities. It can not be claimed that they turned in any way upon the construction of the word "income," as it is used in the Sixteenth Amendment, or that they in any way held the increased value of investment sold or unsold under ordinary circumstances would be regarded as income rather than capital. And as late as the October term, 1917, the Court said in ***Lynch vs. Turrish***, 247 U. S. 230, referring to ***Gray vs. Darlington***:

> "This case has not been since questioned or modified."

And further said:

> "Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

STATE INCOME TAX LAWS.

Counsel for the Government contends that in framing the state income laws it has been customary to include the increased value of investments when sold, and to subject them to taxation.

A somewhat careful examination of state statutes has enabled us to find no state income tax law which has been held to extend to the increased value of investments, except where the Act expressly included increased value of investments. Where it was the legislative intent to cover not only that which we have contended was income, but also to reach increased value of investments which we contend is capital, the purpose of so extending the rule has been set out specifically in the state statutes, and it has been deemed by their authors necessary to clearly declare in the statutes that the increased value of investments were to be subject to the tax.

Instead of this line of legislative enactments being of aid to the Government in support of its contention, they are definite evidence of the fact that state Legislatures have not understood the word "income" to apply to increases in the value of capital, whether sold or unsold.

When we sent to the Legislatures the Sixteenth Amendment they saw it used only the term "income." It did not provide that the word "income" should extend to the increased value of capital. As in their

own acts, they specify increased value of investments for tax if it was intended it should be taxed, when the Sixteenth Amendment reached them without any such specification, they naturally understood it did not apply to increased value of investments.

THE DEPARTMENT SHOULD NOT CONSTRUE THE INCOME TAX ACT OF 1916 TO LEVY A TAX UPON THE GROWTH OF INCREMENT IN VALUE OF CAPITAL ASSETS WHEN REALIZED BY SALE.

We do not insist that the language of the income tax act of 1916 is clear. It contains conflicting provisions. We have already undertaken to show that if the tax act of 1916 should be construed to levy the tax upon the growth of increment in value of capital assets when realized by sale, the act would be unconstitutional.

The act of 1913 did not tax realized increment. In the briefs of counsel, the contention is elaborately and ably presented that the Revenue act of 1913 did not tax realized increment of value, and that the changes in phraseology in the act of 1916 do not indicate any intent so to broaden the scope of income taxes as to construe realized increment as an item of taxable income.

The statute under consideration levies a tax on incomes, etc. It then defines "income" to consist of gains, profits and income. If the words "gains" and "profits," and the other words used, be construed to come within the boundary of the word "income," they are harmless, as they are useless. But if they be construed to have a wider significance or to include something more than income, then they collide with the Constitution and the law must fall.

The law in question can be harmonized with the Constitution, with the precedents of this Court, with the understanding of the Congress at the time the Sixteenth Amendment was adopted, by placing upon the word "income" the interpretation given to it in the case of *Gray vs. Darlington,* and by holding that the word "income" as used in the statute, does not include unearned increment, increase of capital value or profits arising from the sale of capital assets in isolated transactions.

The economic character and effect of a tax has no bearing upon its constitutionality. A constitutional tax may be uneconomic. And what might be an economic tax may be unconstitutional. It is our contention that this tax, as administered by the Department, and as applied to the profitable sales of capital assets, is both unconstitutional and uneconomic. It has done more to freeze free capital in the hands of its owners than any other law, past or present. It has done more to penalize business and to place brakes on the wheels of commerce than any other fiscal experiment in the annals of this country.

WHAT DID CONGRESS AND THE STATES INTEND THE WORDS "INCOME FROM WHATEVER SOURCE DERIVED," IN THE SIXTEENTH AMENDMENT, TO MEAN?

We have called attention to the history of the amendment; to the legislative enactments; to the judicial precedents. These are the lights which the Congress consulted for its guidance. Shall we conclude that Congress intended to regard or to disregard the judgment of this court in *Gray vs. Darlington?* That it intended to regard or to disregard the long line of

English decisions to the same effect? That it intended to regard or to disregard the practically uniform precedents that the increase in the value of a trust estate was capital and not income?

From what facts, from what authority, could Congress have arrived at the conviction that an advance in the value of capital realized in an isolated transaction was to be taxed as income and not treated as capital? When this court places itself in the point of view, and in the point of time occupied by Congress when the Sixteenth Amendment was submitted; if it follows its own decisions, if it follows the decisions of the English-speaking courts everywhere, if it follows judicial precedents and analogies, must it not reach the conclusion that, by this amendment it was intended that an increase in capital assets should only be treated as capital and not taxed as income?

T. P. Gore,
Hoke Smith.

Washington, D. C., March 17, 1921.

GOODRICH *v.* EDWARDS, UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF THE STATE OF NEW YORK.

ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

No. 663. Argued March 10, 11, 1921.—Decided March 28, 1921.

1. Profit realized upon the sale of stocks held as an investment is income, and so much of it as accrued after March 1, 1913, is taxable under the Income Tax Laws of 1916, 1917, and the Sixteenth Amendment. P. 534. *Merchants' Loan & Trust Co.* v. *Smietanka*, *ante*, 509.
2. The statute imposes the income tax on the proceeds of a sale of personal property to the extent only that gains are derived therefrom by the vendor; and § 2 (c) is applicable only where a gain over the original capital investment has been realized after March 1, 1913. P. 535.

Reversed in part; affirmed in part.

THE case is stated in the opinion.

Mr. William D. Guthrie, with whom *Mr. Langdon P. Marvin*, *Mr. Henry M. Ward*, *Mr. Herbert Pope* and *Mr. Rush C. Butler* were on the briefs, for plaintiff in error:

The increase in value of property held for investment, when realized by sale, is not "income" within the meaning of the Sixteenth Amendment. Income here is to be taken as having the meaning commonly understood and judicially defined. *Eisner* v. *Macomber*, 252 U. S. 189; *McCulloch* v. *Maryland*, 4 Wheat. 316, 407.

Prior to the Amendment, income had been judicially defined by this court in *Gray* v. *Darlington*, 15 Wall. 63, by the highest courts of many of the States in the law of estates and trusts, and by the courts of Great Britain

and of the British Dominions and Colonies in construing their income tax laws, as excluding increment of value realized upon the sale of property held for investment. To the same effect as *Gray* v. *Darlington*, was the opinion of Mr. Justice Grier in *Bennet* v. *Baker* (footnote to 15 Wall. 67), and the judgment of the Circuit Court in *Chicago, Burlington & Quincy R. R. Co.* v. *Page*, 1 Biss. 461, 466. This court followed and approved *Gray* v. *Darlington* in *Lynch* v. *Turrish*, 247 U. S. 221.

It must reasonably be presumed that Congress, when it proposed the Sixteenth Amendment, and the state legislatures, when they ratified it, intended to adopt this judicial interpretation and definition of the word income.

The conclusion is, therefore, fully warranted that both those who proposed the Sixteenth Amendment and those who ratified it understood and appreciated the force and effect of the decision of this court in *Gray* v. *Darlington*, and acted upon the belief that such a deliberate and authoritative definition of "income" and "capital" for purposes of taxation would constitute at once the measure and the limitation of the extension of the power of Congress "to lay and collect taxes on incomes . . . without apportionment," so as not to conflict with the constitutional provisions requiring direct taxes on property to be apportioned.

Particularly must it be apparent that this was the understanding of the state legislatures, since they knew that it was universally held to be the law in the United States that a gain realized by a trustee upon the sale of a part of the *corpus* or principal of a trust fund constituted capital or principal and not income, and belonged to the remainderman and not to the life tenant, when the life tenant was, by the express terms of the instrument creating the trust, entitled to all income arising from the trust estate.

That this common and familiar distinction did not

directly appertain to taxation, is quite immaterial. Indeed, this court has so held in *Towne* v. *Eisner*, 245 U. S. 418, 426.

For many years prior to the adoption of the Sixteenth Amendment, the British courts had held and have since continued to hold that capital in any form, whether the realized increment of value upon the sale of property by an individual or of capital assets by a corporation, is not taxable as income under the British income tax laws which have been in force since 1842. This British authority is peculiarly important in view of the well-known fact that American income tax legislation came to us from England and has always been in large part patterned after the English enactments (Black, Income Taxes, 4th ed., § 30); and it should, therefore, reasonably be presumed that both the Sixteenth Amendment and the income tax acts were framed in the light of the British precedents, and "that Congress, in adopting the language of the English act, had in mind the constructions given to these words by the English courts, and intended to incorporate them into the statute." *Interstate Commerce Commission* v. *Baltimore & Ohio R. R. Co.*, 145 U. S. 263, 284. See also *Interstate Commerce Commission* v. *Delaware, Lackawanna & Western R. R. Co.*, 220 U. S. 235, 253-4; *McDonald* v. *Hovey*, 110 U. S. 619, 628. The rule to this effect, thus settled in England and Scotland, also prevails in the British Colonies and Dominions.

Prior, therefore, to 1909 when the Sixteenth Amendment was proposed and 1913 when it was finally adopted, the word "income" was generally understood and had been quite generally defined as having a meaning distinct from, and exclusive of, the increment of value realized upon the sale of property held for investment, by an individual, or the capital assets of a corporation.

If the views expressed by this court subsequent to 1913 be analyzed, this conclusion is strongly reinforced.

The so-called "income" which measured the corporation tax was not and was not intended to be the "income" signified and intended in and by the Sixteenth Amendment, and it has been repeatedly recognized by this court that the senses in which the terms were used are different in the two cases. *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414, 416, and other cases.

Where, on the other hand, a true income tax act was involved and capital profits were realized upon the change of an investment under circumstances in nowise related to the carrying on of business, as in *Gray* v. *Darlington*, 15 Wall. 63; or where under a true income tax law capital profits were realized, not in the course of the business, but upon the winding-up and termination thereof, which is after all but another mode or form of changing an investment, as was the case in *Lynch* v. *Turrish*, 247 U. S. 221, the court in each instance declared that the increment remained capital, despite its conversion or transmutation into cash. And this court has recently stated that "enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Eisner* v. *Macomber*, 252 U. S. 214, 215.

An increase in the value of an investment, not made or held as a part of any trade or business transaction, is plainly "a gain accruing to capital" and a "growth or increment of value in the investment," within the definition of the court in *Eisner* v. *Macomber*, *supra*. In no proper sense does it proceed from the property, as do rents, interest, dividends and other familiar forms of income; and such a gain, when realized, cannot properly be described as "severed from the capital" for it remains an integral part of the capital as much as if it had not been converted.

Before conversion into money, no one would question that the property was capital, although it then included the enhancement of value. Bearing in mind that the

Sixteenth Amendment is not to be "extended by loose construction" and that it is "essential to distinguish between what is and what is not 'income' . . . according to truth and substance, without regard to form" (*Eisner* v. *Macomber,* 252 U. S. 206), we must find some distinct benefit to the taxpayer as income directly attributable to the conversion, before it can be declared that what the taxpayer now has is, not merely his capital, but income instead. Otherwise, the mere fact of conversion, that is, the form alone, would prevail over the substance and be made the decisive factor. Yet the court has declared, although in considering the Act of 1909, that "subsequent change of form by conversion into money did not change the essence." *Doyle* v. *Mitchell Brothers Co.,* 247 U. S. 187.

Mere conversion of capital investments and change into money cannot, therefore, be determinative, even though more money is thus actually brought to hand than was originally put into the investment several years before. Otherwise, *Lynch* v. *Turrish,* 247 U. S. 221, was wrongly decided.

The Income Tax Law of 1916 does not levy a tax upon the increment in value of capital assets when realized by sale.

As the sale or conversion of the stock of the Goodrich Company represented an actual loss, no part of the proceeds was taxable as income of the taxpayer.

The Solicitor General for defendant in error:

Prior to the adoption of the Sixteenth Amendment, the word "income," as understood by the legislative, the executive, and the judicial branches of the Government, included gains or profits derived from the sale of capital assets. Act of August 5, 1861, c. 45, 12 Stat. 292; Seligman, Income Tax, p. 435; Act of July 1, 1862, c. 119, 12 Stat. 432, 473; Cong. Globe, May 27, 1864, p.

2516; Act of June 30, 1864, c. 173, 13 Stat. 223; Act of March 3, 1865, c. 78, 13 Stat. 469; Act of March 2, 1867, c. 169, 14 Stat. 471; *Gray* v. *Darlington*, 15 Wall. 63, 65, 66; Act of August 27, 1894, c. 349, 28 Stat. 509; *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601; Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 11, 112; T. D. 1571; T. D. 1606, § 71; T. D. 1675, Art. 55; T. D. 1742; *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415; *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 183, 185, 187; *Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189, 191–193; *Lynch* v. *Turrish*, 247 U. S. 221, 226; *Eisner* v. *Macomber*, 252 U. S. 189, 207.

In the framing of state income tax laws it has been customary to treat income as including gains derived from the sale of capital assets.

The cases under the Act of 1913 dealing with the distribution of corporate assets among stockholders are in no way in conflict with the Government's contention in this case. *Lynch* v. *Hornby*, 247 U. S. 339; *Eisner* v. *Macomber*, *supra*; *Lynch* v. *Turrish*, *supra*; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Peabody* v. *Eisner*, 247 U. S. 347. These cases establish the proposition that gains derived from the sale of capital assets constitute income when received.

Investments are ordinarily made in contemplation of two kinds of returns,—one current income while the investment is held, and the other the profit to be realized, through appreciation in value, upon the final disposition of the investment.

The debates in Congress, when the Act of 1913 was under consideration, do not show an understanding that such gains as are now in question were not understood to be income.

The tax on gains derived from the sale of property is not confined to such gains arising from transactions conducted as a part of one's business or trade.

Whether under the decisions of the English courts gains of this kind are treated as income can have no determining effect in deciding the question now at issue.

The fact that under the laws of various States gains derived from the sale of capital assets are, as between a life tenant and a remainderman, treated as principal and not as income, affords no reason for saying that such gains are not income which Congress may tax.

The construction of the Act of 1916, under which the taxes in this case were collected, does not work any more hardship or injustice than is inevitable under any general tax law.

But the statute imposes the tax, upon a sale of property, only where there is a gain over the original investment.

Mr. Hoke Smith and *Mr. T. P. Gore*, by leave of court, filed a brief as *amici curiæ*.

MR. JUSTICE CLARKE delivered the opinion of the court.

The plaintiff in error sued the defendant, a collector of Internal Revenue, to recover income taxes assessed in 1920 for the year 1916 and paid under protest to avoid penalties. A demurrer to the complaint was sustained and the constitutional validity of a law of the United States is so involved, that the case is properly here by writ of error. *Towne* v. *Eisner*, 245 U. S. 418.

Two transactions are involved.

(1) In 1912 the plaintiff in error purchased 1,000 shares of the capital stock of a mining company for which he paid $500. It is averred that the stock was worth $695 on March 1, 1913, and that it was sold in March, 1916, for $13,931.22. The tax which the plaintiff in error seeks to recover was assessed on the difference between the

value of the stock on March 1, 1913, and the amount for which it was sold.

(2) The plaintiff in error being the owner of shares of the capital stock of another corporation, in 1912 exchanged them for stock, in a reorganized company, of the then value of $291,600. It is averred and admitted that on March 1, 1913, the value of this stock was $148,635.50, and that it was sold in 1916 for $269,346.25. Although it is thus apparent that the stock involved was of less value on March 1, 1913, than when it was acquired, and that it was ultimately sold at a loss to the owner, nevertheless the collector assessed the tax on the difference between the value on March 1, 1913, and the amount for which it was sold.

The plaintiff in error seeks to recover the whole of these two assessments.

The same contention is made with respect to each of these payments as was made in No. 608, *Merchants' Loan & Trust Co.* v. *Smietanka*, this day decided, *ante*, 509, viz, that the amounts realized from the sales of the stocks were in their inherent nature capital as distinguished from income, being an increment in value of the securities while owned and held as an investment and therefore not taxable under the Revenue Act of 1916 (39 Stat. 756) as amended in 1917 (40 Stat. 300) or under any constitutional law.

With respect to the first payment. It is plain that this assessment was on the profit accruing after March 1, 1913, the effective date of the act, realized to the owner by the sale after deducting his capital investment. The question involved is ruled by No. 608, *supra*, and the amount was properly taxed.

As to the second payment. The Government confesses error in the judgment with respect to this assessment. The stock was sold in the year for which the tax was assessed for $22,253.75 less than its value when it was

acquired, but for $120,710.75 more than its value on March 1, 1913, and the tax was assessed on the latter amount.

The act under which the assessment was made provides that the net income of a "taxable person shall include *gains*, profits, and income derived from . . . sales, or dealings in property, whether real or personal, . . . or *gains* or profits and income derived from any source whatever." (39 Stat. 757; 40 Stat. 300, 307.)

Section 2 (c) of this same act provides that "for the purpose of ascertaining the *gain* derived from a sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such *gain* derived."

And the definition of "income" approved by this court is: "'The *gain* derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets." *Eisner* v. *Macomber*, 252 U. S. 189, 207.

It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that *gains* are derived therefrom by the vendor, and we therefore agree with the Solicitor General that since no gain was realized on this investment by the plaintiff in error no tax should have been assessed against him.

Section 2 (c) is applicable only where a gain over the original capital investment has been realized after March 1, 1913, from a sale or other disposition of property.

It results that the judgment of the District Court as to the first assessment, as we have described it, is affirmed, that as to the second assessment it is reversed, and the case

is remanded to that court for further proceedings in conformity with this opinion.

Reversed in part.
Affirmed in part.

MR. JUSTICE HOLMES and MR. JUSTICE BRANDEIS, because of prior decisions of the court, concur only in the judgment.